[JOINT COMMITTEE PRINT]

SIMPLIFICATION OF PRESENT-LAW TAX RULES RELATING TO QUALIFIED PENSION PLANS (S. 1364, THE EMPLOYEE BENEFITS SIMPLIFICATION AND EXPANSION ACT OF 1991, AND S. 318)

SCHEDULED FOR A HEARING

BEFORE THE

SUBCOMMITTEE ON PRIVATE RETIREMENT PLANS

OF THE

SENATE COMMITTEE ON FINANCE

ON

SEPTEMBER 27, 1991

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

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INTRODUCTION

The Subcommittee on Private Retirement Plans of the Senate Committee on Finance has scheduled a public hearing on September 27, 1991, to review the Internal Revenue Code rules relating to private pension plans and possible options for simplification of pension plan rules. The hearing will focus on S. 1364, the Employee Benefits Simplification and Expansion Act of 1991, introduced by Senator Bentsen for Senator Pryor on June 25, 1991, and S. 318, introduced by Senator Packwood and others on January 31, 1991.

This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of present law and the provisions of S. 1364, and a discussion of issues relating to simplification of the Federal income tax rules applicable to tax-qualified retirement plans. Part I of the pamphlet is a summary. This is followed by a description of the present-law Federal tax rules regarding tax-qualified plans (Part II), a description of S. 1364 (Part III), a discussion of pension plan simplification issues (Part IV), and a description of S. 318 (Part V).

[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Simplification of Present-Law Tax Rules Relating to Qualified Pension Plans (S. 1364, the Employee Benefits Simplification and Expansion Act of 1991, and S. 318)* (JCS-13-90), September 26, 1991.

I. SUMMARY

Present-law rules relating to qualified plans

A plan of deferred compensation that meets the qualification standards of the Internal Revenue Code (a qualified plan) is accorded special tax treatment under present law. The employer maintaining the plan is entitled to a current deduction (within limits) for contributions to a qualified plan even though an employee is not required to include qualified plan benefits in income until the benefits are distributed from the plan. The purpose of the tax benefits for qualified plans is to encourage employers to establish nondiscriminatory retirement plans for their employees.

Qualified plans are broadly classified into two categories: defined contribution plans and defined benefit pension plans. There are several different types of defined contribution plans, including money purchase pension plans, profit-sharing plans, stock bonus plans, and employee stock ownership plans (ESOPs).

The qualification standards and related rules governing qualified plans are generally designed to ensure that qualified plans benefit an employer's rank-and-file employees as well as the employer's highly compensated employees. They also define the rights of plan participants and beneficiaries and provide limits on the tax deferral possible under qualified plans.

The qualification rules include minimum participation rules that limit the age and service requirements an employer can impose as a requirement of participation in a plan; coverage and nondiscrimination rules designed to prevent qualified plans from discriminating in favor of highly compensated employees; vesting and accrual rules which limit the period of service an employer can require before an employee earns or becomes entitled to a benefit under a plan; limitations on the contributions made on behalf of and benefits of a plan participant; and minimum funding rules designed to ensure the solvency of defined benefit pension plans. The Code also contains rules regarding the taxation of qualified plan benefits; terminations of qualified plans; and rules designed to prevent plan fiduciaries and others closely associated with a plan from misusing plan assets.

The present-law rules governing qualified plans originated in the Employee Retirement Income Security Act of 1974 (ERISA). ERISA forms the basis for the current private pension system. The rules enacted in ERISA have been revised several times. The most comprehensive revision to the qualification rules since the enactment of ERISA was made by the Tax Reform Act of 1986.

Summary of S. 1364

S. 1364, the Employee Benefits Simplification and Expansion Act of 1991, modifies the present-law rules relating to qualified plans

and certain other types of employee benefit plans. In particular, the Act (1) modifies the definition of highly compensated employee; (2) changes the timing of cost-of-living adjustments to dollar limits applicable to certain pension requirements and provides for rounding of such limits; (3) provides an additional safe harbor definition of compensation; (4) modifies the minimum participation rule (sec. 401(a)(26)) and provides that the rule (as modified) applies only to defined benefit pension plans; (5) provides design-based safe harbor rules for satisfying the special nondiscrimination rules applicable to qualified cash or deferred arrangements (sec. 401(k)) and employer matching contributions (sec. 401(m)); (6) modifies the distribution rules relating to pension plans by (a) liberalizing the circumstances in which a distribution may be rolled over tax free, (b) repealing 5-year averaging for lump-sum distributions from qualified plans, (c) requiring that certain distributions be transferred tax free in a trustee-to-trustee transfer to an eligible transferee plan, and (d) repealing the requirement that distributions to qualified plan participants begin by age 70-1/2 (sec. 401(a)(9)) and generally replacing it with the required beginning date in effect before the Tax Reform Act of 1986; (7) modifies the definition of leased employee; (8) provides that the 150 percent of current liability full funding limit does not apply to multiemployer plans; (9) expands the circumstances under which a group of unrelated employers may establish a voluntary employees' beneficiary association (VEBA); (10) modifies the limits on contributions and benefits (sec. 415) as they apply to governmental plans; (11) broadens the availability of simplified employee pensions (SEPs), and provides design-based safe harbor rules for satisfying the special nondiscrimination rules applicable to such plans; (12) permits tax-exempt organizations to establish and maintain qualified cash or deferred arrangements (sec. 401(k)); and (13) makes other miscellaneous changes to the pension rules.

Simplification issues

The Federal laws and regulations governing employer-provided retirement benefits are recognized as among the most complex set of rules applicable to any area of the tax law. There are several sources for this complexity, including the interaction of retirement policy and tax policy, the volume and frequency of employee benefits legislation, the structure of the workplace, the need to take into account the great variety of compensation and benefit packages, the desire for certainty in the law, and transition rules.

In analyzing any proposal to simplify the pension rules, the following issues are important: (1) the extent to which the proposed change is consistent with the underlying policy objectives of the rule that is altered; (2) whether a complete revision of rules that employers and plan administrators understand and use should be made solely in the interest of simplification; (3) whether additional legislation with respect to a rule that has already been subject to significant legislation itself creates complexity; (4) the extent to which transition rules and grandfather rules contribute to complexity; and (5) whether any attempt to simplify the rules relating to employer-provided pension plans should be required to be revenue neutral with respect to present law.

Summary of S. 318

S. 318, the PRIME Retirement Account of 1991, creates a simplified retirement plan for small business called the private retirement incentives matched by employers (PRIME) account. A PRIME account is an individual retirement plan with respect to which employees can make elective pre-tax contributions of up to $3,000 per year, with a 100-percent employer match up to 3 percent of the employee's compensation. No nondiscrimination rules apply to PRIME accounts.

Only employers who normally employ fewer than 100 employees and who do not maintain a qualified plan can establish PRIME accounts for their employees. All employees of the employer who are reasonably expected to work at least 1,000 hours during the year are eligible to participate in the PRIME account. All contributions to an employee's PRIME account are fully vested. Simplified reporting requirements apply.

II. PRESENT-LAW RULES [2]

A. Overview of Qualified Plans

In general

A plan of deferred compensation that meets the qualification standards of the Internal Revenue Code (a qualified plan) is accorded special tax treatment under present law. Employees do not include qualified plan benefits in gross income until the benefits are distributed even though the plan is funded and the benefits are nonforfeitable. Tax deferral is provided under qualified plans from the time contributions are made until the time benefits are received. The employer is entitled to a current deduction (within limits) for contributions to a qualified plan even though an employee's income inclusion is deferred. Contributions to a qualified plan are held in a tax-exempt trust.

The special tax benefits for qualified plans and qualified plan benefits represent a significant tax expenditure. For fiscal year 1991, the tax expenditure for the net exclusion for pension contributions and earnings is estimated to be $52.2 billion.[3]

The policy rationale for this tax expenditure is that the tax benefits for qualified plans encourage employers to provide retirement benefits for their employees. This reduces the need for public assistance and reduces pressure on the social security system.

The qualification standards and related rules governing qualified plans are designed to ensure that qualified plans benefit an employer's rank-and-file employees as well as highly compensated employees. They also define the rights of plan participants and beneficiaries and provide some limit on the tax benefits for qualified plans.

Qualified plans are broadly classified into two categories based on the nature of the benefits provided: defined contribution plans and defined benefit pension plans.

Under a defined benefit pension plan, benefit levels are specified under a plan formula. Benefits under a defined benefit pension plan are funded by the general assets of the trust established under the plan; individual accounts are not maintained for employees participating in the plan.[4]

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[2] This pamphlet is limited to a discussion of the Internal Revenue Code rules relating to tax-qualified retirement plans. In addition to the rules in the Internal Revenue Code, the labor law provisions of the Employee Retirement Income Security Act of 1974 (ERISA) contain extensive rules regarding employee benefit pension plans. For a more detailed description of the qualification rules, see Joint Committee on Taxation, *Present-Law Tax Rules Relating to Qualified Pension Plans* (JCS-9-90), March 22, 1990.

[3] *See* Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 1991-1995* (JCS-7-90), March 9, 1990.

[4] Individual accounts may be maintained for after-tax employee contributions made to a defined benefit pension plan.

Benefits under defined contribution plans are based solely on the contributions (and earnings thereon) allocated to separate accounts maintained for each plan participant. There are several different types of defined contribution plans, including money purchase pension plans, target benefit plans, profit-sharing plans, stock bonus plans, and employee stock ownership plans (ESOPs). A profit-sharing or stock bonus plan, a pre-ERISA money purchase pension plan, or a rural cooperative plan may include a qualified cash or deferred arrangement (sec. 401(k)). Under such an arrangement, an employee may elect to have the employer make payments as contributions to a plan on behalf of the employee, or to the employee directly in cash. The various different types of plans are in part historical and reflect the various different ways in which employers structure deferred compensation programs for their employees.

Sanction for failure to meet qualification rules

If a plan fails to meet the qualification standards, then the special tax benefits for qualified plans do not apply, and benefits and contributions are taxed under normal income tax rules. In general, if a plan fails to meet the qualification standards, then contributions to the plan are includible in employees' gross income when such contributions are no longer subject to a substantial risk of forfeiture (secs. 402(b) and 83). Amounts actually distributed or made available to an employee are generally includible in income in the year distributed or made available under the rules applicable to taxation of annuities (sec. 72). Special sanctions apply in the case of failure to meet certain qualification rules.

An employer is generally not entitled to a deduction for contributions to a nonqualified plan until the contributions are includible in an employee's gross income.

Simplified employee pensions

Under a simplified employee pension (SEP), contributions are made to individual retirement arrangements (IRAs) established on behalf of each participant. SEPs are not subject to the general qualification rules and are intended to provide an employer with a retirement savings arrangement for the employer's employees that requires a minimum of administrative work.

In general, employer contributions to a SEP are required to be made on behalf of each employee who has attained age 21, has performed service for the employer during at least 3 of the immediately preceding 5 years, and received at least $300 in compensation from the employer for the year. Present law permits employers with 25 or fewer employees to maintain salary reduction SEPs. As under a qualified cash or deferred arrangement, employees who participate in a salary reduction SEP are permitted to elect to have the employer make payments as contributions to the SEP or to receive the contributions in cash.

Present law provides that the election to have amounts contributed to a SEP or received in cash is available only if at least 50 percent of the employees of the employer elect to have amounts contributed to the SEP. In addition, the amount eligible to be deferred as a percentage of each highly compensated employee's compensation (i.e., the deferral percentage) is limited by the average

deferral percentage (based solely on elective deferrals) for all nonhighly compensated employees who are eligible to participate in the salary reduction SEP.

B. Plan Qualification Requirements

1. Coverage and nondiscrimination requirements

Key among the qualification standards are coverage and nondiscrimination rules designed to ensure that qualified plans benefit a significant number of an employer's rank-and-file employees as well as highly compensated employees. These rules include numerical minimum coverage rules (sec. 410(b)), a minimum participation rule requiring that a plan benefit a minimum number of employees (sec. 401(a)(26)), and a general nondiscrimination requirement (sec. 401(a)(4)). Special nondiscrimination rules apply to qualified cash or deferred arrangements, employer matching contributions, and after-tax employee contributions.

a. Minimum participation rule

A plan is not a qualified plan unless it benefits no fewer than the lesser of (a) 50 employees of the employer or (b) 40 percent of all employees of the employer (sec. 401(a)(26)). This requirement may not be satisfied by aggregating comparable plans, but may be applied separately to different lines of business of the employer. In the case of a cash or deferred arrangement or the portion of a defined contribution plan (including the portion of a defined benefit plan treated as a defined contribution plan (sec. 414(k)) to which employee contributions or employer matching contributions are made, an employee will be treated as benefiting under the plan if the employee is eligible to make or receive contributions under the plan.

A special sanction applies to violations of the minimum participation rule. Under this sanction, if one of the reasons a plan fails to be a qualified plan is because it fails either the coverage rules or the minimum participation rule, then highly compensated employees are to include in income the value of their vested accrued benefit as of the close of the year in which the plan fails to qualify. Nonhighly compensated employees are not taxed on their benefits if the only reason a plan is not a qualified plan is a failure to satisfy the coverage requirements or the minimum participation rule.

b. Nondiscrimination in contributions or benefits

A qualified plan may not discriminate in favor of highly compensated employees with respect to contributions or benefits under the plan (sec. 401(a)(4)). This general nondiscrimination requirement applies to all plan aspects, including those not addressed under the numerical coverage tests. Thus, it may apply not only with respect to contributions or benefits, but also with respect to optional forms of benefit and other benefits, rights, and plan features such as actuarial assumptions, rates of accrual methods of benefit calculation, loans, social security supplements, and disability benefits.

Whether or not a plan meets the general nondiscrimination test is a factual determination, based on the relevant facts and circumstances. A plan does not fail to meet the general nondiscrimination

test if contributions or benefits bear a uniform relationship to compensation. The Secretary issued final regulations under the general nondiscrimination rules on September 19, 1991.

c. Nondiscrimination rules relating to qualified cash or deferred arrangements

In general

A profit-sharing or stock bonus plan, a pre-ERISA money purchase pension plan, or a rural cooperative plan may include a qualified cash or deferred arrangement (sec. 401(k)). Under such an arrangement, an employee may elect to have the employer make payments as contributions to a plan on behalf of the employee, or to the employee directly in cash. Contributions made at the election of the employee are called elective deferrals. The maximum annual amount of elective deferrals that can be made by an individual is $7,000 (indexed) ($8,475 for 1991). A special nondiscrimination test applies to cash or deferred arrangements.

The special nondiscrimination test applicable to elective deferrals under qualified cash or deferred arrangements is satisfied if the actual deferral percentage for eligible highly compensated employees for a plan year is equal to or less than either (1) 125 percent of the actual deferral percentage of all nonhighly compensated employees eligible to defer under the arrangement, or (2) the lesser of 200 percent of the actual deferral percentage of all eligible nonhighly compensated employees or the actual deferral percentage for all eligible nonhighly compensated employees plus 2 percentage points. The actual deferral percentage for a group of employees is the average of the ratios (calculated separately for each employee in the group) of the contributions paid to the plan on behalf of the employee to the employee's compensation.

If a cash or deferred arrangement satisfies the special nondiscrimination test, it is treated as satisfying the general nondiscrimination rules (sec. 401(a)(4)) with respect to the amount of elective deferrals. However, the group of employees eligible to participate in the arrangement is still required to satisfy the minimum coverage test (sec. 410(b)).

Excess contributions

If the special nondiscrimination rules are not satisfied for any year, the qualified cash or deferred arrangement will not be disqualified if the excess contributions (plus income allocable to the excess contributions) are distributed before the close of the following plan year. In addition, under Treasury regulations, instead of receiving an actual distribution of excess contributions, an employee may elect to have the excess contributions treated as an amount distributed to the employee and then contributed by the employee to the plan on an after-tax basis.

Excess contributions mean, with respect to any plan year, the excess of the aggregate amount of elective deferrals paid to the cash or deferred arrangement and allocated to the accounts of highly compensated employees over the maximum amount of elective deferrals that could be allocated to the accounts of highly compensated employees without violating the nondiscrimination re-

quirements applicable to the arrangement. To determine the amount of excess contributions and the employees to whom the excess contributions are to be distributed, the elective deferrals of highly compensated employees are reduced in the order of their actual deferral percentages beginning with those highly compensated employees with the highest actual deferral percentages.

Excise tax on excess contributions

An excise tax is imposed on the employer making excess contributions to a qualified cash or deferred arrangement (sec. 4979). The tax is equal to 10 percent of the excess contributions (but not earnings on those contributions) under the arrangement for the plan year ending in the taxable year. However, the tax does not apply to any excess contributions that, together with income allocable to the excess contributions, are distributed or, in accordance with Treasury regulations, recharacterized as after-tax employee contributions no later than 2-1/2 months after the close of the plan year to which the excess contributions relate.

Excess contributions (plus income) distributed or recharacterized within the applicable 2-1/2-month period are to be treated as received and earned by the employee in the employee's taxable year in which the excess contributions would have been received as cash, but for the employee's deferral election. For purposes of determining the employee's taxable year in which the excess contributions are includible in income, the excess contributions are treated as the first contributions made for a plan year. Of course, distributions of excess contributions (plus income) within the applicable 2-1/2-month period are not taxed a second time in the year of distribution.

d. Nondiscrimination rules relating to employer matching contributions and employee contributions

In general

A special nondiscrimination test is applied to employer matching contributions and employee contributions under qualified defined contribution plans (sec. 401(m)).[5] This special nondiscrimination test is similar to the special nondiscrimination test applicable to qualified cash or deferred arrangements. Contributions which satisfy the special nondiscrimination test are treated as satisfying the general nondiscrimination rules (sec. 401(a)(4)) with respect to the amount of contributions.

The term "employer matching contributions" means any employer contribution made on account of (1) an employee contribution or (2) an elective deferral under a qualified cash or deferred arrangement.

The special nondiscrimination test is satisfied for a plan year if the contribution percentage for eligible highly compensated employees does not exceed the greater of (1) 125 percent of the contribution percentage for all other eligible employees, or (2) the lesser of 200 percent of the contribution percentage for all other eligible employees, or such percentage plus 2 percentage points. The contri-

[5] These rules also apply to certain employee contributions to a defined benefit pension plan.

bution percentage for a group of employees for a plan year is the average of the ratios (calculated separately for each employee in the group) of the sum of matching and employee contributions on behalf of each such employee to the employee's compensation for the year.

Treatment of excess aggregate contributions

As under the rules relating to qualified cash or deferred arrangements, if the special nondiscrimination test is not satisfied for any year, the plan will not be disqualified if the excess aggregate contributions (plus income allocable to such excess aggregate contributions) are distributed before the close of the following plan year. Generally, the amount of excess aggregate contributions and their allocation to highly compensated employees is determined in the same manner as with respect to excess deferrals.

Excise tax on excess aggregate contributions

An excise tax is imposed on the employer with respect to excess aggregate contributions (sec. 4979). The tax is equal to 10 percent of the excess aggregate contributions (but not earnings on those contributions) under the plan for the plan year ending in the taxable year for which the contributions are made.

However, the tax does not apply to any excess aggregate contributions that, together with income allocable to the excess aggregate contributions, are distributed (or, if nonvested, forfeited) no later than 2-1/2 months after the close of the plan year in which the excess aggregate contributions arose.

2. Limitations on contributions and benefits

In general

Under present law, overall limits are provided on contributions and benefits under qualified plans based on the type of plan (sec. 415). The overall limits apply to all such contributions and benefits provided to an individual by any private or public employer. However, certain special rules apply to governmental plans.

Defined contribution plans

Under a defined contribution plan, the qualification rules limit the annual additions to the plan with respect to each plan participant to the lesser of (1) 25 percent of compensation or (2) $30,000 (sec. 415(c)). Annual additions are the sum of employer contributions, employee contributions, and forfeitures with respect to an individual under all defined contribution plans of the same employer. The $30,000 limit will be increased when $30,000 is less than one-fourth of the dollar limit on benefits under a defined benefit pension plan (see below).

Under present law, an employer may elect to continue deductible contributions to a defined contribution plan on behalf of an employee who is permanently and totally disabled. An individual is considered permanently and totally disabled if the individual is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which

can be expected to result in death or which has lasted or can be expected to last for a continuous period of at least 12 months.

For purposes of the limit on annual additions (sec. 415(c)), the compensation of a disabled employee is deemed to be equal to the annualized compensation of the employee prior to the employee's becoming disabled.

Contributions are not permitted on behalf of disabled employees who were officers, owners, or highly compensated before they became disabled.

Defined benefit pension plans

In general

Under present law, the limit on the annual benefit payable by a defined benefit pension plan is generally the lesser of (1) 100 percent of average compensation, or (2) $108,963 for 1991 (sec. 415(b)).[6] The dollar limit is adjusted annually for cost-of-living increases. The dollar limit is reduced proportionately for individuals with less than 10 years of participation in the plan.

The dollar limit on annual benefits is reduced if benefits under the plan begin before the social security retirement age so that the limit is actuarially equivalent to a benefit beginning at the social security retirement age. If retirement benefits provided by a defined benefit pension plan begin after the social security retirement age, the dollar limit is increased so that it is the actuarial equivalent of the dollar limit applicable to a benefit beginning at the social security retirement age.

Present law provides that a minimum benefit can be paid even if the benefit exceeds the normally applicable benefit limitations. Thus, the overall limits on benefits are deemed to be satisfied if the retirement benefit of a participant under all defined benefit pension plans of the employer does not exceed $10,000 for a year or any prior year, and the participant has not participated in a defined contribution plan of the employer. The $10,000 limit is reduced for participants with less than 10 years of participation in the plan.

Special rules for plans of State and local governments

Special rules apply to State and local governmental plans. For such plans, the rules in effect prior to the Tax Reform Act of 1986 apply with respect to the limits on annual benefits. Accordingly, the actuarial reduction of the dollar limit on annual benefits for early retirement does not reduce the limit (1) for benefits commencing on or after the participant has attained age 62 (rather than the social security retirement age), (2) below $75,000 for benefits commencing on or after the participant has attained age 55, or (3) below the actuarial equivalent of $75,000 payable at age 55, for benefits commencing before age 55.

Present law also contains a special rule that permits a plan maintained by a State or local government to provide benefits to

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[6] Annual benefits may in some cases exceed this dollar limitation under grandfather and transition rules contained in the Tax Equity and Fiscal Responsibility Act of 1982 and other legislation.

qualified participants equal to the accrued benefit of the participant (without regard to any benefit increases pursuant to a plan amendment adopted after October 14, 1987) even though such benefit exceeds the otherwise applicable limits on benefits (sec. 415(b)(10)). A qualified participant is a participant who first became a participant in the plan before January 1, 1990.

The special rule does not apply unless the employer elects, by the close of the first plan year beginning after December 31, 1989, to have the normal limits on contributions and benefits apply to all plan participants other than qualified participants. A plan maintained by an electing employer may not use the special actuarial reduction rules for early retirement benefits generally available to State and local government plans.

This special rule was enacted under the Technical and Miscellaneous Revenue Act of 1988 (TAMRA) out of recognition that some governmental plans did not conform to the limit on contributions and benefits due to State constitutional prohibitions on impairment of contracts. The special rule was designed to bring State and local government plans into conformity with the general rules, and to provide temporary relief from such rules in the case of certain plans.

Combined plan limitation

An additional limitation applies if an employee participates in a defined benefit pension plan and a defined contribution plan maintained by the same employer. This combined plan limitation prevents avoidance of the separate plan limits through the creation of different types of plans. The limit permits an employee to obtain benefits greater than the single-plan limitation, but precludes an individual from obtaining the maximum possible benefits from both a defined contribution plan and a defined benefit pension plan of the same employer.

3. Definitions

a. Highly compensated employee

In general

For purposes of the qualification rules, an employee, including a self-employed individual, is treated as highly compensated with respect to a year if, at any time during the year or the preceding year, the employee (1) was a 5-percent owner of the employer (as defined under the top-heavy rules); (2) received more than $90,803 in annual compensation from the employer; (3) received more than $60,535 in annual compensation from the employer and was a member of the top-paid group of the employer during the same year; or (4) was an officer of the employer who received compensation greater than $54,482. These dollar amounts are adjusted annually for inflation at the same time and in the same manner as the adjustments to the dollar limit on benefits under a defined benefit pension plan (sec. 415(d)). If, for any year, no officer has compensation in excess of $54,482, then the highest paid officer of the employer for such year is treated as a highly compensated employee.

An employee is not treated as in the top-paid 20 percent, as an officer, or as receiving $90,803 or $60,535 solely because of the employee's status during the current year, unless such employee also is among the 100 employees who have received the highest compensation during the year.

Election to use simplified method

Employers are permitted to elect to determine their highly compensated employees under a simplified method. Under this method, an electing employer may treat employees who received more than $60,535 in annual compensation from the employer as highly compensated employees in lieu of applying the $90,803 threshold and without regard to whether such employees are in the top-paid 20 percent. This election is available only if at all times during the year the employer maintained business activities and employees in at least 2 geographically separate areas.

Treatment of family members

A special rule applies with respect to the treatment of family members of certain highly compensated employees. Under the special rule, if an employee is a family member of either a 5-percent owner or 1 of the top 10 highly compensated employees by compensation, then any compensation paid to such family member and any contribution or benefit under the plan on behalf of such family member is aggregated with the compensation paid and contributions or benefits on behalf of the 5-percent owner or the highly compensated employee in the top 10 employees by compensation. Therefore, such family member and employee are treated as a single highly compensated employee.

An individual is considered a family member if, with respect to an employee, the individual is a spouse, lineal ascendant or descendant, or spouse of a lineal ascendant or descendant of the employee.

b. Compensation

The definition of compensation varies with the purpose for which the definition is used. The Tax Reform Act of 1986 attempted to provide a uniform definition of compensation (sec. 414(s)). This definition in turn is based on the definition of compensation for purposes of the limits on contributions and benefits (sec. 415).

For purposes of the limits on contributions and benefits compensation generally includes all compensation includible in gross income. Thus, it includes amounts received for personal services actually rendered in the course of employment, amounts received under an accident or health plan (to the extent that such amounts are includible in gross income), nondeductible moving expenses paid or reimbursed by the employer, and the value of certain nonqualified stock options (to the extent includible in gross income). Compensation for this purpose also includes earned income from sources outside the United States whether or not excludable or deductible from gross income. Compensation does not include contributions to qualified plans and distributions from such plans (even if includible in gross income), amounts realized from the exercise of nonqualified stock options, amounts realized from the sale of stock

acquired under a qualified stock option, or other amounts that receive special tax benefits, such as premiums for group-term life insurance (to the extent not includible in gross income).

Compensation that is not currently taxable or that receives special tax treatment is generally excluded for purposes of calculating the limits on benefits and contributions because including such amounts would provide additional tax benefits to amounts that already receive tax-favored treatment.

Under the "uniform" definition of compensation that is used for nondiscrimination testing, compensation generally has the same definition as compensation for purposes of the limits on contributions and benefits. However, under this definition, an employer may elect to include elective deferrals by the employee. In addition, the Secretary of the Treasury is authorized to provide for alternative methods of defining compensation, provided such definitions do not discriminate in favor of highly compensated employees. The Secretary issued final regulations on September 19, 1991 specifying permissible definitions of compensation.

In determining who is a highly compensated employee (sec. 414(q)), compensation is defined as under the limits on contributions and benefits, except that compensation includes elective deferrals made by an employee. Elective deferrals are treated as compensation for this purpose because they reflect amounts that could have been paid in cash to the employee and are therefore part of the employee's economic income.

c. Employer and employee

In general

For purposes of plan qualification requirements, all employees of certain entities must be aggregated and treated as though employed by a single employer. Under these rules, all employees are considered employed by the same entity to the extent they are employed by corporations that are members of a controlled group (sec. 414(b)), trades or businesses under common control (e.g., related partnerships) (sec. 414(c)), or members of an affiliated service group (sec. 414(m)). In addition, individuals are treated as employees to the extent they are leased employees (sec. 414(n)). The Secretary of the Treasury is authorized to prescribe by regulations such additional aggregation rules as are necessary to prevent the avoidance of the qualification rules through the use of separate organizations, employee leasing, or other arrangements (sec. 414(o)).

Leased employees

An individual (a leased employee) who performs services for another person (the recipient) may be treated as the recipient's employee if the services are performed pursuant to an agreement between the recipient and a third person (the leasing organization) who is otherwise treated as the individual's employer. The individual is to be treated as the recipient's employee only if the individual has performed services for the recipient on a substantially full-time basis (i.e., at least 1500 hours) for a period of at least 12 months, and the services are of a type historically performed by employees in the recipient's business field.

An individual who otherwise would be treated as a recipient's leased employee will not be treated as such an employee if the individual participates in a safe harbor plan maintained by the leasing organization. A plan is a safe harbor plan if it is a money purchase pension plan and if it provides that (1) an individual is a plan participant on the first day on which the individual becomes an employee of an employer maintaining the plan, (2) each employee's rights to or derived from employer contributions under the plan are nonforfeitable at the time the contributions are made, and (3) amounts are to be contributed by the employer on behalf of an employee at a rate not less than 10 percent of the employee's compensation for the year (the 10 percent contribution is not to be reduced by integration with social security).

Each leased employee is to be treated as an employee of the recipient, regardless of the existence of a safe-harbor plan, if more than 20 percent of an employer's nonhighly compensated workforce are leased employees.

C. Treatment of Distributions

1. Uniform minimum distribution rules

Present law provides uniform minimum distribution rules generally applicable to all types of tax-favored retirement vehicles, including qualified plans and annuities, individual retirement arrangements (IRAs), and tax-sheltered annuities (sec. 403(b)).

Under present law, a qualified plan is required to provide that the entire interest of each participant will be distributed beginning no later than the participant's required beginning date (sec. 401(a)(9)). The required beginning date is generally the April 1 of the calendar year following the calendar year in which the plan participant or IRA owner attains age 70-1/2. In the case of a governmental plan or a church plan, the required beginning date is the later of (1) such April 1, or (2) the April 1 of the year following the year in which the participant retires.

Under present law, the sanction for failure to make a minimum required distribution to a participant (or other payee) under a qualified retirement plan is a 50-percent nondeductible excise tax on the excess in any taxable year of the amount required to have been distributed under the minimum distribution rules, over the amount that actually was distributed (sec. 4974). The tax is imposed on the individual required to take the distribution. However, a plan will not satisfy the applicable qualification requirements unless it expressly provides that, in all events, distributions under the plan are to satisfy the minimum distribution requirements.

2. Withdrawal rules

Present law limits the circumstances under which plan participants may obtain preretirement withdrawals from a qualified plan. In general, these restrictions recognize that qualified plans are intended to provide retirement income.

The least restrictive withdrawal rules apply to profit-sharing and stock bonus plans. Amounts may generally be withdrawn from such plans after they have been in the plan for 2 years. Distributions before the expiration of such 2-year period may also be made

in the event of retirement, death, disability, other separation from service, or hardship.

Distributions from qualified pension plans (i.e., defined benefit pension plans and money purchase pension plans) may generally be made only in the event of retirement, death, disability, or other separation from service. The same restrictions generally apply to plans that are integrated with social security.

Special rules apply to qualified cash or deferred arrangements (sec. 401(k)). Elective deferrals under a qualified cash or deferred arrangement (and earnings thereon) may only be distributed on account of separation from service, death, or disability, or attainment of age 59-1/2. Elective deferrals (but not earnings thereon) may also be distributed on account of a hardship of the employee.

Present law generally prohibits State or local governments or tax-exempt organizations from maintaining qualified cash or deferred arrangements. This prohibition does not apply to a pension plan maintained by a rural cooperative, which is generally defined as (1) any organization that is exempt from tax or which is a State or local government or instrumentality thereof, and which is engaged primarily in providing electric service on a mutual or cooperative basis, (2) a cooperative telephone company, (3) certain tax-exempt organizations, and (4) a national association of such organizations. Because a rural cooperative plan is a pension plan, the rule permitting hardship distributions and distributions after age 59-1/2 but before separation from service from a qualified cash or deferred arrangement does not apply.

3. Taxation of distributions [7]

In general

Under present law, a distribution of benefits from a tax-favored retirement arrangement generally is includible in gross income in the year it is paid or distributed under the rules relating to taxation of annuities, unless the amount distributed represents the employee's investment in the contract (i.e., basis) (secs. 72 and 402). Special rules apply in the case of lump-sum distributions from a qualified plan, distributions that are rolled over to an IRA, and distributions of employer securities.

Early distributions from qualified plans and other tax-favored retirement vehicles are subject to an additional 10-percent income tax (sec. 72(t)). Excess distributions from qualified plans and other tax-favored retirement vehicles are subject to a 15-percent tax (sec. 4980A).

Rollovers

Under present law, a total or partial distribution of the balance to the credit of an employee under a qualified plan, a qualified annuity plan, or a tax-sheltered annuity may, under certain conditions, be rolled over tax free to an IRA or another qualified plan or

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[7] The rules relating to the taxation of pension distributions were substantially revised in the Tax Reform Act of 1986. The 1986 Act contains a number of detailed transition rules which preserve the pre-1986 Act tax treatment in certain circumstances. For a detailed description of these rules, see Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* (JCS-10-87), May 4, 1987.

annuity. A rollover of a partial distribution is permitted if (1) the distribution equals at least 50 percent of the balance to the credit of the employee, (2) the distribution is not one of a series of periodic payments, and (3) the employee elects rollover treatment. A partial distribution may only be rolled over to an IRA and not to another qualified plan.

The maximum amount of a distribution that can be rolled over is the amount of the distribution that is taxable. That is, employee contributions cannot be rolled over. The rollover must be made within 60 days after the distribution was received.

Lump-sum distributions

Under present-law, lump-sum distributions are eligible for special 5-year forward income averaging. In general, a lump-sum distribution is a distribution within one taxable year of the balance to the credit of an employee which becomes payable to the recipient (1) on account of the death of the employee, (2) after the employee attains age 59-1/2, (3) on account of the employee's separation from service, or (4) in the case of self-employed individuals, on account of disability. In addition, a distribution to an employee is treated as a lump-sum distribution only if the employee has been a participant in the plan for at least 5 years before the year of the distribution.

A taxpayer is permitted to make an election with respect to a lump-sum distribution received on or after the employee attains age 59-1/2 to use 5-year forward income averaging under the tax rates in effect for the taxable year in which the distribution is made. However, only one such election on or after age 59-1/2 may be made with respect to any employee.

Net unrealized appreciation

Under present law, a taxpayer is not required to include in gross income amounts received in the form of a lump-sum distribution to the extent that the amounts are attributable to net unrealized appreciation in employer securities. Such unrealized appreciation is includible in gross income when the securities are sold or exchanged.

The special treatment of net unrealized appreciation applies only if a valid lump-sum distribution election is made, but disregarding the 5-plan years of participation requirement for lump-sum distributions.

In addition, gross income does not include net unrealized appreciation on employer securities attributable to employee contributions, regardless of whether the securities are received in a lump-sum distribution. Such appreciation is includible in income when the securities are disposed of.

D. Funding Rules

Under the Code, certain defined benefit pension plans and money purchase pension plans are required to meet a minimum funding standard for each plan year (sec. 412). The minimum funding standards are designed to ensure that pension plans have sufficient assets to pay benefits.

In the case of a money purchase pension plan, the contribution required by the minimum funding standard is generally the contribution rate specified by the plan. Defined benefit pension plans are funded on an actuarial basis. A special funding rule that requires faster funding applies to underfunded single-employer defined benefit pension plans.

No contribution is required or permitted under the minimum funding rules to the extent the plan is at the full funding limitation. In addition, under present law, subject to certain limitations, an employer may make deductible contributions to a defined benefit pension plan up to the full funding limitation. The full funding limitation is generally defined as the excess, if any, of (1) the lesser of (a) the accrued liability under the plan (including normal cost) or (b) 150 percent of the plan's current liability, over (2) the lesser of (a) the fair market value of the plan's assets, or (b) the actuarial value of the plan's assets (sec. 412(c)(7)).

E. Voluntary Employees' Beneficiary Associations (VEBAs)

Statutory requirements

A voluntary employees' beneficiary association (VEBA) that satisfies certain requirements is entitled to tax-exempt status. The Code describes VEBAs in the following broad terms: "Voluntary employees' beneficiary associations providing for the payment of life, sick, accident, or other benefits to the members of such association or their dependents or designated beneficiaries, if no part of the net earnings of such association inures (other than through such payments) to the benefit of any private shareholder or individual" (sec. 501(c)(9)). The requirements a VEBA must comply with in order to be tax exempt are further specified in regulations.

The tax-exempt status of a VEBA does not directly affect either (1) the timing or amount of an employer's deduction for contributions to the VEBA or (2) the timing or amount of the inclusion in income of a welfare benefit provided to an employee under a plan. Many VEBAs provide benefits to employees that are excluded from gross income under a specific statutory provision.

Eligibility for membership

Under Treasury regulations, membership in a VEBA is required to be limited to individuals whose eligibility is determined by reference to objective standards that constitute an employment-related common bond. Such a common bond is deemed to exist if eligibility is determined by the following standards: (1) employment by a common employer (or affiliated employers), (2) coverage under one or more collective bargaining agreements, (3) membership in a labor union (or in one or more locals of a national or international labor union), or (4) employment by one or more employers in the same line of business in the same geographic locale. Under these standards, for example, a group of car dealers in the same city or other similarly restricted discrete geographical locale could form a VEBA to provide permissible benefits to their employees. In *Water*

Quality Assn. Employees' Benefit Corp. vs. U.S., the 7th Circuit found the geographic locale restriction invalid.[8]

The regulations do not provide guidance with respect to the determination of when a group of employers is considered to be affiliated and, therefore, eligible to contribute to the same VEBA. The Code generally defines affiliated organizations by reference to ownership. However, the IRS has at times taken the position that other factors may be relevant (see G.C.M. 39194, June 23, 1983).

Membership in a VEBA generally is limited to employees. Under the regulations, the term employee means an individual who has a legal and bona fide relationship of employer and employee (e.g., for employment tax purposes or for purposes of a collective bargaining agreement).

The regulations provide that membership in a VEBA must be voluntary, which requires an affirmative action by the employee to become a member. An employer may automatically include employees provided no detriment is incurred (e.g., deductions from pay) as a result of membership. Such a detriment can be incurred, however, if membership is imposed pursuant to a collective bargaining agreement or incident to membership in a labor organization.

Membership in a VEBA may not be limited to one employee.

Association of employees

A VEBA is not considered an association of employees unless the organization is controlled by (1) the membership, (2) independent trustees, or (3) trustees at least some of whom are designated by, or on behalf of, the membership. The regulations provide that a VEBA is treated as being controlled by independent trustees if it is an "employee welfare benefit plan" under title I of the Employee Retirement Income Security Act of 1974 (ERISA). ERISA subjects employee welfare benefit plans to certain reporting and disclosure requirements and minimum fiduciary standards. If these standards are satisfied, the employer (or an officer of the employer) may serve as trustee of the VEBA.

F. Reporting of Pension and Annuity Payments

The penalty reform provisions of the Omnibus Budget Reconciliation Act of 1989 revised the penalties imposed for failures to file correct and timely information returns with the IRS, and to provide statements to payees. This revised penalty structure applies to 18 different types of reportable payments. However, this structure does not apply to reports of pension and annuity payments required under section 6047(d). It also does not apply to certain reports required by sections 408(i) and 408(l) relating to IRAs and SEPs.

[8] 795 F. 2d 1303 (7th Cir. 1986).

III. DESCRIPTION OF S. 1364

A. Title I—Nondiscrimination Provisions

Definition of highly compensated employee

The bill provides that an employee is highly compensated with respect to a year if the employee (1) was a 5-percent owner of the employer at any time during the year or the preceding year, or (2) has compensation for the year in excess of $50,000. As under present law, the $50,000 threshold is adjusted for cost-of-living increases in the same manner as the limitations on contributions and benefits (sec. 415(d)). Under the bill, as under present law, the dollar limit in effect for 1991 is $60,535.

Under the bill, if no employee is a 5-percent owner or has compensation in excess of $50,000 (indexed), then the highest paid officer for the year is treated as a highly compensated employee. This special rule does not apply for purposes of the nondiscrimination rules applicable to elective deferrals, matching contributions, and employee contributions (secs. 401(k) and (m)), and does not apply with respect to employees of tax-exempt organizations and State and local governments (sec. 457(e)(1)).

The bill applies the present-law family member aggregation rule only in the case of family members of a 5-percent owner.

This provision is generally effective for years beginning after December 31, 1991. An employer may elect not to have the provision apply to years beginning in 1992.

Modifications of cost-of-living adjustments

Under present law, the cost-of-living adjustments to the limitations on contributions and benefits under qualified plans are made in accordance with procedures consistent with the adjustment of benefits under the Social Security Act. The bill provides that the cost-of-living adjustment with respect to any calendar year is based on the increase in the applicable index as of the close of the calendar quarter ending September 30 of the preceding calendar year. Thus, under the bill, adjusted dollar limits will be published before the beginning of the calendar year. In addition, the bill provides that, after cost-of-living adjustments, the resulting dollar limits are generally rounded to the nearest $1,000. Under the bill, dollar limits relating to elective deferrals and elective contributions to simplified employee pensions (SEPs) are rounded to the nearest $100.

The cost-of-living adjustment provisions apply to adjustments with respect to calendar years beginning after December 31, 1991.

Definition of compensation

The bill permits an employer to elect to use base pay as a permissible definition of compensation for purposes of all provisions which specifically refer to section 414(s) of the Code. An employer making such an election may also elect to take into account employee elective and salary reduction contributions. It is intended that base pay is defined generally as under the regulations (Treas. reg. sec. 1.414(s)-1(d)). Thus, subject to the applicable facts and circumstances, the employer could exclude from the definition of compensation, on a consistent basis, certain types of compensation, including (but not limited to) one or more of the following: any type of additional compensation for employees working outside their regularly scheduled tour of duty (such as overtime pay, premiums for shift differential, and call-in premiums); bonuses; or reimbursements or other expense allowances, fringe benefits (cash and noncash), moving expenses deferred compensation, and welfare benefits. It is intended that the resulting definition may not discriminate in favor of highly compensated employees. The election applies for purposes of all applicable provisions and to all employees, and may be revoked only with the consent of the Secretary.

The provision is generally effective for years beginning after December 31, 1991.

Modification of additional participation requirements

The bill provides that the minimum participation rule (sec. 401(a)(26)) applies only to defined benefit pension plans. In addition, the bill provides that a defined benefit pension plan does not satisfy the rule unless it benefits no fewer than the lesser of (1) 25 employees or (2) the greater of (a) 40 percent of all employees of the employer or (b) 2 employees (1 employee if there is only 1 employee). The separate line of business and excludable employee rules apply as under present law. As an illustration of the operation of the modification of the minimum participation rule, assume that an employer has 150 nonexcludable employees. Under present law, any plan of the employer is required to cover a minimum of 50 employees. Under the bill, any defined benefit plan of the employer is required to cover a minimum of 25 employees.

In the case of an employer with only 2 employees, a plan satisfies the present-law minimum participation rule if the plan covers 1 employee. However, under the bill, a plan satisfies the minimum participation rule only if it covers both employees.

The provision is generally effective for years beginning after December 31, 1991. An employer may elect to have the provision apply as if it were included in section 1112(b) of the Tax Reform Act of 1986.

Nondiscrimination rules for qualified cash or deferred arrangements and matching contributions

In general

The bill adds alternative methods of satisfying the special nondiscrimination requirements applicable to elective deferrals and employer matching contributions. Under these safe harbor rules, a cash or deferred arrangement is treated as satisfying the actual de-

ferral percentage test if the plan of which the arrangement is a part (or any other plan of the employer maintained with respect to the employees eligible to participate in the cash or deferred arrangement) meets (1) one of two contribution requirements and (2) a notice requirement. A plan satisfies the safe harbor with respect to matching contributions if (1) the plan meets the contribution and notice requirements under the safe harbor for cash or deferred arrangements and (2) the plan satisfies a special limitation on matching contributions. These safe harbors permit a plan to satisfy the special nondiscrimination tests through plan design, rather than through the testing of actual contributions to the plan.

Safe harbor for cash or deferred arrangements

Contribution requirements.—A plan satisfies the contribution requirements under the safe harbor rule for qualified cash or deferred arrangements if the plan either (1) satisfies a matching contribution requirement or (2) the employer makes a nonelective contribution to the plan of at least 3 percent of an employee's compensation on behalf of each nonhighly compensated employee who is eligible to participate in the arrangement without regard to whether the employee makes an elective contribution under the arrangement.

A plan satisfies the matching contribution requirement if, under the arrangement: (1) the employer makes a matching contribution on behalf of each nonhighly compensated employee that is not less than (a) 100 percent of the employee's elective contributions up to 3 percent of compensation and (b) 50 percent of the employee's elective contributions from 3 to 5 percent of compensation; and (2) the level of match for highly compensated employees is not greater than the match rate for nonhighly compensated employees.

Alternatively, if the matching contribution requirement is not satisfied at some level of employee compensation, the requirement is deemed to be satisfied if (1) the level of employer matching contributions does not increase as employee elective contributions increase and (2) the aggregate amount of matching contributions with respect to elective contributions up to that level of compensation at least equals the amount of matching contributions that would be made if matching contributions satisfied the percentage requirements. For example, the alternative test is satisfied if an employer matches 125 percent of an employee's elective contributions up to the first 3 percent of compensation, 25 percent of elective deferrals of 4 percent of compensation and provides no match thereafter. This is because the employer match does not increase and the aggregate amount of matching contributions is at least equal to the matching contributions required under the general safe harbor rule.

Under the safe harbor, an employee's rights to employer matching contributions or nonelective contributions used to meet the contribution requirements are required to be 100-percent vested.

An arrangement does not satisfy the contribution requirements unless the requirements are met without regard to the permitted disparity rules (sec. 401(l)) and contributions used to satisfy the contribution requirements are not taken into account for purposes of

determining whether a plan of the employer satisfies the permitted disparity rules.

Employer matching and nonelective contributions used to satisfy the contribution requirements of the safe harbor rules are subject to the restrictions on withdrawals that apply to an employee's elective deferrals under a qualified cash or deferred arrangement (sec. 401(k)(2)(B) and (C)).

The contribution requirement may be satisfied with either matching or nonelective contributions to the cash or deferred arrangement or with contributions to another plan maintained by the employer for the same employees eligible to participate in the cash or deferred arrangement.

Notice requirement.—The notice requirement is satisfied if each employee eligible to participate in the arrangement is given written notice within a reasonable period before any year of the employee's rights and obligations under the arrangement. This notice must be sufficiently accurate and comprehensive to apprise the employee of his or her rights and obligations and must be written in a manner calculated to be understood by the average employee eligible to participate.

Alternative method of satisfying special nondiscrimination test for matching contributions

The bill provides a safe harbor method of satisfying the special nondiscrimination test applicable to employer matching contributions. Under this safe harbor, a plan is treated as meeting the special nondiscrimination test if (1) the plan meets the contribution and notice requirements applicable under the safe harbor method of satisfying the special nondiscrimination requirement for qualified cash or deferred arrangements, and (2) the plan satisfies a special limitation on matching contributions.

The limitation on matching contributions is satisfied if (1) matching contributions on behalf of any employee may not be made with respect to employee contributions or elective deferrals in excess of 6 percent of compensation and (2) the level of an employer's matching contribution does not increase as an employee's contributions or elective deferrals increase.

Distribution of excess contributions

Under the bill, the total amount of excess contributions is determined in the same manner as under present law, but the distribution of excess contributions is required to be made on the basis of the amount of contribution by, or on behalf of, each highly compensated employee. Thus, under the bill, excess contributions are deemed attributable first to those highly compensated employees who have made the greatest dollar amount of elective deferrals under the plan.

For example, assume that an employer maintains a qualified cash or deferred arrangement under section 401(k). Assume further that the actual deferral percentage ("ADP") for the eligible nonhighly compensated employees is 2 percent. In addition, assume the following facts with respect to the eligible highly compensated employees:

Employees	Compensation	Deferral	Deferral (percent)
A	$200,000	$7,000	3.5
B	200,000	7,000	3.5
C	70,000	7,000	10.0
D	70,000	5,250	7.5
E	70,000	2,100	3.0
F	70,000	1,750	2.5

Under these facts, the highly compensated employees' ADP is 5 percent, which fails to satisfy the special nondiscrimination requirements.

Under present law, the highly compensated employees with the highest deferral percentages would have their deferrals reduced until the ADP of the highly compensated employees is 4 percent. Accordingly, C and D would have their deferrals reduced to $4,025 (i.e., a deferral percentage of 5.75 percent). The reduction thus is $2,975 for C and $1,225 for D, for a total reduction of $4,200.

Under the bill, the amount of the total reduction is calculated in the same manner as under present law so that the total reduction remains $4,200. However, this total reduction of $4,200 is allocated to highly compensated employees based on the employees with the largest contributions. Thus, A, B, and C would each be reduced by $1,400 from $7,000 to $5,600.

Effective date

The provisions relating to the special nondiscrimination tests applicable to qualified cash or deferred arrangements and matching contributions are applicable to years beginning after December 31, 1991.

B. Title II—Distributions

In general

The bill expands the circumstances in which a distribution may be rolled over tax free and eliminates 5-year averaging for lump-sum distributions from qualified plans. The bill also provides that certain distributions are required to be transferred directly into another tax-deferred retirement arrangement.

Rollovers

Under the bill, any distribution to the employee or the surviving spouse of the employee (other than a minimum required distribution (sec. 401(a)(9)) may be rolled over tax free to an IRA or another qualified plan or annuity. As under present law, employee contributions cannot be rolled over.

This provision is effective with respect to distributions after December 31, 1991.

Special rules for lump-sum distributions

The bill repeals the special 5-year forward averaging rule. The original intent of the income averaging rules for pension distributions was to prevent a bunching of taxable income because a taxpayer received all of the benefits in a qualified plan in a single taxable year. Liberalization of the rollover rules increases the flexibility of taxpayers in determining the time of the income inclusion of pension distributions, and eliminates the need for special rules to prevent bunching of income. The bill preserves the transition rules adopted in the Tax Reform Act. The bill also retains the present-law treatment of net unrealized appreciation on employer securities and generally retains the definition of lump-sum distribution solely for such purpose.

This provision is effective with respect to distributions after December 31, 1991.

Transfers to IRAs or other eligible transferee plans

The bill provides that any applicable distribution that would otherwise be distributed to an employee or the surviving spouse of the employee is to be transferred directly to an eligible transferee plan rather than distributed to the employee or surviving spouse. In general, an applicable distribution is any distribution in excess of $500 other than (1) distributions in the form of substantially equal periodic payments (as defined under sec. 72(t)), (2) a distribution made after the employee attains age 55, (3) a distribution attributable to the employee being disabled (as defined in sec. 72(m)(7)), (4) distributions of deductible dividends on employer securities (sec. 404(k)), (5) distributions to an alternate payee, (6) hardship distributions from a profit-sharing or stock bonus plan, or (7) distributions of employee contributions.

The transfer requirement applies only to amounts that, but for the transfer requirement, would otherwise be distributed to the recipient. Thus, for example, the transfer requirement does not apply to amounts that are deemed to be distributed under the rules relating to participant loans (sec. 72(p)). In addition, the transfer requirement applies after other rules relating to distributions. For example, if the plan is subject to the joint and survivor rules (secs. 401(a)(11) and 417) those rules would have to be complied with before the transfer is made.

The distribution may be transferred to an IRA or to a qualified defined contribution plan that provides for the acceptance of the transfer. The transfer is to be made to the IRA or qualified plan designated by the distributee within a reasonable period of time before the transfer in accordance with regulations. The plan is to provide a method by which the plan trustee is to designate the transferee plan in the event the distributee does not make a designation or transfer to the designated plan is impracticable.

Amounts transferred are includible in income when distributed from the transferee plan in accordance with the rules applicable to the transferee plan. However, if the distributee withdraws all or a portion of the amount transferred by the due date (including extensions) for filing the distributee's tax return for the year the transfer was made, the distribution is treated as if it had been made

from the transferor plan. Thus, for example, if a distribution is transferred to an IRA and the employee makes a withdrawal of transferred amounts (plus income) from the IRA, the exemptions to the early distribution tax applicable to qualified plans (rather than the rules applicable to IRA withdrawals) apply. This rule is designed to prevent individuals who do not want the distribution to remain in a tax-favored arrangement from being disadvantaged by the transfer.

The plan trustee is required to notify employees of the requirements of the transfer rules and of the amount of any transfer. Once the transfer is made to the transferee plan in accordance with applicable Code provisions, the employer is relieved of all responsibility for the amounts transferred.

A plan is not treated as violating the prohibition on reduction of accrued benefits (sec. 411(d)(6)) solely by reason of the transfer. For purposes of determining years of service and the buy-back rules (sec. 411(a)(7)), a transfer is treated as a distribution.

Similar rules apply to distributions from qualified annuities (sec. 403(a)) and tax-sheltered annuities (sec. 403(b)).

These provisions apply to distributions in plan years beginning after December 31, 1992.

Required distributions from qualified plans

The bill repeals the rule that requires all participants in qualified plans to commence distributions by age 70-1/2 without regard to whether the participant is still employed by the employer and, therefore, generally replaces it with the rule in effect prior to the Tax Reform Act. Thus, under the bill, distributions are required to begin by April 1 of the calendar year following the later of (1) the calendar year in which the employee attains age 70 or (2) the calendar year in which the employee retires. In the case of a 5-percent owner of the employer, distributions are required to begin no later than the April 1 of the calendar year following the year in which the 5-percent owner attains age 70. Distributions from an IRA are required to begin no later that April 1 of the calendar year following the year in which the IRA owner attains age 70.

In addition, in the case of an employee (other than a 5-percent owner) who retires in a calendar year after attaining age 70, the bill requires the employee's accrued benefit to be actuarially increased to take into account the period after age 70 in which the employee was not receiving benefits under the plan. Thus, under the bill, the employee's accrued benefit is required to reflect the value of benefits that the employee would have received if the employee had retired at age 70 and had begun receiving benefits at that time.

The actuarial adjustment rule and the rule requiring 5-percent owners to begin distributions after attainment of age 70 does not apply, under the bill, in the case of a governmental plan or church plan.

This provision applies to years beginning after December 31, 1991.

C. Title III—Miscellaneous Provisions

Treatment of leased employees

The bill replaces the historically performed test in the definition of leased employee with a control test. Thus, under the bill an individual is a leased employee of a service recipient if the services are performed by the individual under the control of the recipient (and the other requirements are satisfied).

The provision is effective for taxable years beginning after December 31, 1983.

Elimination of half-year requirements

Under present law, a number of employee plan rules refer to the age of an individual at a certain time. For example, distributions under a qualified pension plan are generally required to begin no later than the April 1 following the year in which an individual attains age 70-1/2 (sec. 401(a)(9)). Similarly, an additional income tax on early withdrawals applies to certain distributions from qualified pension plans and IRAs prior to the time the participant or IRA owner attains age 59-1/2 (sec. 72(t)).

The bill changes the half-year requirements to birthdate requirements. Those rules under present law that refer to age 59-1/2 are changed to refer to age 59, and those that refer to age 70-1/2 are changed to refer to age 70.

The provision applies to distributions in years beginning after December 31, 1991.

Plans covering self-employed individuals

Prior to the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) different rules applied to retirement plans maintained by incorporated employers and unincorporated employers (such as partnerships and sole proprietors). In general, plans maintained by unincorporated employers were subject to special rules in addition to the other qualification requirements of the Code. Most, but not all, of this disparity was eliminated by TEFRA.

Under present law, certain special aggregation rules apply to plans maintained by owner-employees that do not apply to other qualified plans (sec. 401(d)(1) and (2)). The bill eliminates these special rules.

The provision applies to years beginning after December 31, 1991.

Full funding limitation of multiemployer plans

The bill provides that the 150 percent of current liability limitation does not apply to multiemployer plans. In addition, the bill repeals the present-law annual valuation requirement for multiemployer plans and applies the prior-law rule that valuations be performed at least every 3 years.

The provision applies to years beginning after December 31, 1991.

Affiliation requirements for employers jointly maintaining a VEBA

The bill provides that otherwise unrelated employers are treated as affiliated and, therefore, can maintain a tax-exempt VEBA if

the employers (1) are in the same line of business, (2) act jointly to perform tasks which are integral to the activities of each of the employers, and (3) act jointly to such an extent that the joint maintenance of a VEBA is not a major part of the joint activities.

Under the bill, employers are considered affiliated, for example, under the following circumstances. The employers participating in the VEBA are in the same line of business and belong to an association that provides to its members a significant amount of each of the following services: (1) research and development relating to the members' primary activity; (2) education and training of members' employees; and (3) public relations. In addition, the employers are sufficiently similar (e.g., subject to similar regulatory requirements) that the association's services provide material assistance to all of the employers. The employers also demonstrate the importance of their joint activities by having meetings at least annually attended by substantially all of the employers. Finally, the employers maintain a common retirement plan.

On the other hand, it is not intended that the mere existence of a trade association is a sufficient basis for the member-employers to be considered affiliated, even if they are in the same line of business. It is also not sufficient if the trade association publishes a newsletter and provides significant public relations services, but only provides nominal amounts, if any, of other services integral to the employers' primary activity.

A group of employers are also not considered affiliated under the bill by virtue of the membership of their employees in a professional association.

The bill is intended as a clarification of present law. However, it is not intended to create any inference as to whether any part of the Treasury regulations affecting VEBAs, other than the affiliated employer rule, is or is not present law.

Modifications to simplified employee pensions

The bill conforms the eligibility requirements for SEP participation to the rules applicable to pension plans generally by providing that contributions to a SEP must be made with respect to each employee who has at least one year of service with the employer.

The bill modifies the rules relating to salary reduction SEPs by providing that such SEPs may be established by employers with 100 or fewer employees. The bill also repeals the requirement that at least half of eligible employees actually participate in a salary reduction SEP.

The bill also provides that an employer meets the requirements of the 125 percent deferral percentage test for salary reduction contributions if the employer makes a nonforfeitable contribution to the plan of at least 3 percent of an employee's compensation on behalf of each nonhighly compensated employee who is eligible to participate in the arrangement without regard to whether the employee makes an elective contribution under the arrangement.

The provision applies to years beginning after December 31, 1991.

Contributions on behalf of disabled employees

The bill provides that the special rule for contributions on behalf of disabled employees is applicable without an employer election and to highly compensated employees if the defined contribution plan provides for the continuation of contributions on behalf of all participants who are permanently and totally disabled.

The provision applies to years beginning after December 31, 1991.

Distributions from rural cooperative plans

The bill provides that distributions can be made from a rural cooperative plan which includes a qualified cash or deferred arrangement upon attainment of age 59, even if the plan is not a profit-sharing or stock bonus plan.

The provision is effective as if included in the amendments made by section 1011(k)(9) of the Technical and Miscellaneous Revenue Act of 1988.

Reporting of pension and annuity payments

The bill provides that the definition of "information return" under section 6724(d) includes reports of pension and annuity payments required by section 6047(d), and any report required under subsection (i) or (l) of section 408. Similarly, the definition of "payee statement" under section 6724(d)(2) is amended to include reports of pension and annuity payments required by section 6047(d) and any report required under subsection (i) or (l) of section 408. The bill provides that section 6652(e) is amended to delete reports of designated distributions from the scope of its $25 per day penalty.

The bill provides a $10 reporting threshold for designated distributions.

The provision applies to returns and statements required to be filed after December 31, 1991.

Treatment of certain governmental plans

The bill provides that (1) compensation for purposes of the limitations on benefits and contributions under a qualified plan maintained by a State or local government includes amounts contributed by the employer pursuant to a salary reduction agreement (2) the compensation limitation on benefits under a defined benefit pension plan does not apply to plans maintained by a State or local government, (3) the defined benefit pension plan limits do not apply to certain disability and survivor benefits provided under such plans, and (4) section 457 does not apply to excess benefit plans maintained by a State or local government. Excess plans maintained by a State or local government are subject to the same tax rules applicable to excess plans maintained by private employers (e.g., sec. 83).

The bill also permits government employers to revoke the special TAMRA election under which plans could provide benefits equal to the accrued benefit of participants notwithstanding the otherwise applicable limits on benefits. Plans maintained by employers that revoke the election could then use the special actuarial reduction

rules for early retirement benefits generally applicable to governmental plans. To be effective, the revocation must filed with the Secretary of the Treasury by the last day of the third plan year beginning after the date of enactment of the bill. The revocation would apply to all plan years for which the election was in effect, except that the benefit limitations for benefits paid after the date of revocation, but attributable to a preceding taxable year during which such election was in effect, will be determined as if such amount had been received in such preceding taxable year.

The provision generally is effective for taxable years beginning after the date of enactment. However, a qualified plan maintained by a State or local government shall be treated as satisfying the requirements of section 415 for all taxable years before the date of enactment.

Date for adoption of plan amendments

The bill provides that any plan amendments required by the bill are not required to be made before the first plan year beginning on or after January 1, 1993, if the plan is operated in accordance with the applicable provision and the amendment is retroactive to the effective date of the applicable provision.

IV. ISSUES AND ANALYSIS RELATING TO THE SIMPLIFICATION OF EMPLOYEE PENSION BENEFITS TAX LAWS

A. General Simplification Issues

In general

There are three potential sources of income for an individual after retirement—social security benefits, employer-provided pension plan benefits, and personal savings. These three sources of retirement income have traditionally been referred to as the "three-legged stool" providing retirement income security. Taken together, these three sources of income ideally should provide an adequate replacement for preretirement income.

An employer's decision to establish or continue a pension plan for employees is voluntary. The Federal tax laws provide favorable tax treatment for amounts contributed to an employer-provided pension plan to encourage the establishment and continuance of such plans.

The Federal laws and regulations governing employer-provided retirement benefits are recognized as among the most complex set of rules applicable to any area of the tax law. Some have argued that this complexity has made it difficult, if not impossible, for employers, particularly small employers, to comply with the law. In addition, it is asserted that this complexity deters employers from establishing pension plans or forces the termination of such plans. If this assertion is accurate, then the complexity of the employee benefits laws is reducing the number of employees covered under employer-provided plans. Such a result then forces social security and personal savings to assume more of the burden of replacing preretirement income.

Others assert that the complexity of employee benefits laws and regulations is a necessary by-product of attempts (1) to ensure that retirement benefits are delivered to more than just the most highly compensated employees of an employer, (2) to provide employers, particularly large employers, with the flexibility needed to recognize the differences in the way that employers do business; and (3) to ensure that retirement benefits generally are used for retirement purposes.

A brief discussion follows of the reasons for complexity in the pension area.

Reasons for complexity in employee pension benefits laws

Volume and frequency of employee benefits legislation

Many employers and practitioners in the pension area have argued that the volume of legislation affecting pension plans enacted since 1974 has contributed to complexity. In many cases, a particular substantive area of pension law may be dealt with legis-

latively every year. For example, the rules relating to the form and taxation of distributions from qualified pension plans were significantly changed by the Tax Equity and Fiscal Responsibility Act of 1982, the Deficit Reduction Act of 1984, and the Tax Reform Act of 1986. In many cases, changes in the rules are lobbied for by employers and practitioners.

This constant change of the law has not only contributed to complexity for the employer, plan administrator, or practitioner who must understand the rules, but has also created problems for the IRS and Department of Labor. Regulations projects are so backlogged at the IRS that employers may not know what they must do to bring their pension plans into compliance with enacted legislative changes because the IRS has been unable to publish adequate guidance for employers.

The amount of legislation in the pension area in recent years hinders the ability of the IRS and the Department of Labor to monitor compliance with the law. Significant amounts of resources are required to be expended to educate government employees with respect to changes in the law. Time that is spent reviewing pension plan documents to determine whether they qualify under the tax laws in form takes time away from the auditing of plans to ensure that they qualify in operation.

The level of legislative and regulatory activity in the pension area has also created problems because inadequate time is available to consider the possible interaction of various provisions. The IRS may issue regulations that are immediately superseded by legislation. Legislation is enacted that does not consider the potential interaction problems created with other areas of employee benefits law.

Some people argue that the rules relating to employer-provided pension plans should not be significantly altered in the context of an effort to simplify the rules. This argument assumes that additional changes in the employee benefits area will only contribute to complexity by legislating again in an area that some say has been overlegislated in the last 10 years.

On the other hand, legislative initiatives that merely repeal existing rules may not contribute to additional complexity of the rules unless the repeal of such rules leaves uncertainty as to the rule that applies in place of the repealed rule.

The structure of the workplace

Some argue that the complexity of the rules relating to pensions stems from a problem that is not unique to the employee benefits area—that is, the way in which the workplace has developed has created inherent complexities in the way that legislation is enacted. The way in which employers do business affects the complexity of pension legislation.

Large employers tend to have complex structures. These complex structures may include the division of employees among various subsidiaries that are engaged in different types of businesses. Rules are required to deal with the issues that arise because a business is operated in many tiers. For example, questions arise as to which employees are required to be taken into account in determining whether an employer is providing pension benefits on a nondis-

criminatory basis. To what extent are employees of various subsidiaries that are engaged in completely different activities required to be aggregated? If these employees must be aggregated for testing purposes, what kind of recordkeeping burdens are imposed on the employer? How are headquarters employees treated and how does the treatment of such employees differ from the treatment of subsidiary employees? If an employer retains temporary workers, to what extent are such workers required to be taken into account? Should employees covered by collective bargaining agreements be treated differently than other employees? Employers face these issues every day because of the way in which their businesses are operated, rather than simply because the laws governing pension benefits are complex.

Flexibility and complexity

Employers and employees generally want to be able to tailor their compensation arrangements, including pension benefits, to fit their particular goals and circumstances. Present law accommodates these desires by providing for various tax-favored retirement savings vehicles, including qualified plans, individual retirement arrangements (IRAs), simplified employee pensions (SEPs), and tax-sheltered annuities. There are many different types of qualified plans, different ways of funding such plans, and different ways of providing benefits under such plans.

The number of different tax-favored retirement arrangements increases complexity in the pension rules because different rules are needed for each type of arrangement. A great deal of simplicity could be achieved, for example, if employers were permitted to choose from only one or two model pension plans. However, this would also greatly reduce the flexibility provided employers and employees under present law.

To some extent, the complexity of present law is elective. For example, employers who wish to reduce complexity can adopt a master or prototype plan. Similarly, an employer may adopt a simple profit-sharing plan for all his employees that involves a minimum of administrative work. However, many employers choose more complicated compensation arrangements.

Complexity and certainty

Although employers and practitioners often complain about the complexity of the rules relating to employer-provided pension plans, some of that complexity is, in fact, attributable to the desire of employers or the Congress to have certainty in the rules. For example, the general nondiscrimination rule relating to qualified pension plans merely requires that a plan not discriminate in either contributions or benefits in favor of highly compensated employees. This rule is easy to articulate; however, determining whether or not the rule is satisfied is not a simple task. The most obvious problem is determining what the word "discriminate" means. If it means that there can be no difference in contributions or benefits between those provided to highly compensated employees and those provided to rank-and-file employees, then the rule may be fairly straightforward. However, because the rules permit employers some flexibility to provide more contributions or benefits

for highly compensated employees, then it is necessary to determine how much of a difference in the contributions or benefits is permitted.

On the other hand, rules that provide greater certainty for employers tend, on their face, to appear to be more complex. A case in point are the nondiscrimination rules for employee benefits added in the Tax Reform Act of 1986 (Code sec. 89).[9] Employers complained vigorously about the calculations and recordkeeping requirements imposed by section 89. However, these rules developed during the legislative consideration of the 1986 Act in large measure in response to employer's complaints about the uncertainty of a general rule prohibiting nondiscrimination in favor of highly compensated employees.

A more mechanical rule will often appear to be more complex, but will also provide more certainty to the employers, plan administrators, and practitioners who are required to comply with the rule. Thus, any attempts to reduce complexity of the employee benefits laws must balance the desire for simplicity against the perceived need for certainty. In addition, it should be recognized that simplicity in legislation does not preclude complexity in regulation.

Retirement policy vs. tax policy

A source of complexity in the development of pension laws and regulations occurs because the Federal Government has chosen to encourage the delivery of retirement benefits by employers through the Federal income tax system. This decision tends to create conflicts between retirement income policy and tax policy.

Retirement income policy has as its goal the delivery of adequate retirement benefits to the broadest possible class of workers. Because the decision to maintain a retirement plan for employees is voluntary, retirement income policy would argue for laws and regulations that do not unduly hinder the ability or the willingness of an employer to establish a retirement plan. Such a policy might also encourage the delivery of more retirement benefits to rank-and-file employees by adopting a rule that prohibits discrimination in favor of highly compensated employees, but does not otherwise limit the amount of benefits that can be provided to such employees. Thus, an employer whose principal objective was to provide large retirement benefits to highly compensated employees (e.g., management) could do so as long as the employer also provided benefits to rank-and-file employees.

On the other hand, tax policy will be concerned not only with the amount of retirement benefits being delivered to rank-and-file employees, but also with the extent to which the Federal Government is subsidizing the delivery of such benefits. Thus, Federal tax policy requires a balancing of the tax benefits provided to an employer who maintains a qualified plan in relation to all other tax subsidies provided by the Federal tax laws. This balancing has led the Congress (1) to limit the total amount of benefits that may be provided to any one employee by a qualified plan and (2) to adopt strict nondiscrimination rules to prevent highly compensated em-

[9] The rules of section 89 were repealed in 1989. (P.L. 101-140).

ployees from receiving a disproportionate amount of the tax subsidy provided with respect to qualified pension plans.

Jurisdiction of pension legislation

When ERISA was enacted in 1974, the Congress concluded that Federal pension legislation should be developed in a manner that limited the Federal tax subsidy of employer-provided retirement benefits and that provided adequate safeguards for the rights of employees whose employers maintained pension plans. Accordingly, the rules adopted in ERISA included changes in the tax laws governing qualified plans (Title II of ERISA) and also included labor law requirements applicable to employer-provided plans (Title I of ERISA). In many cases, these labor law requirements mirrored the requirements of the tax laws and created a civil right of action for employees. Thus, ERISA ensured that compliance with the Federal employee benefits laws could be monitored by the Federal Government (through the IRS and the Department of Labor) and by employees (through their civil right of action under the labor laws).

Although many of the pension laws enacted in ERISA had mirror provisions in the labor laws and in the Internal Revenue Code, subsequent legislation has not always followed the same form. For example, the top-heavy rules that were enacted as part of the Tax Equity and Fiscal Responsibility Act of 1982 were only included in the Internal Revenue Code and did not contain a corresponding provision in Title I of ERISA. Some have argued that such a piecemeal approach to employee benefits legislation can lead to inconsistencies between the Federal tax law and Federal labor law and can contribute to the overall complexity of the rules governing pension plans.

In addition, the enforcement of rules relating to employer-provided pension plans is shared by the IRS and the Department of Labor. Thus, there is no single agency of the Federal Government that is charged with the development and implementation of regulations and with the operational enforcement of the rules relating to pension plans.

Although the authority of each applicable agency has been clarified, complexity can occur because of the manner in which the agencies interact. An employer must determine the agency with which it must consult on an issue and may find that the goals of each agency are different. For example, the Pension Benefit Guaranty Corporation (PBGC) views the funding of a defined benefit pension plan from its goal of assuring solvency of the plan when benefit payments are due. On the other hand, the IRS is concerned that employers should not be permitted to overfund defined benefit pension plans as a mechanism by which the employer can shelter income from taxation. Without careful coordination of the goals of these 2 Federal agencies, employers may receive inconsistent directives.

Transition rules

When the Congress enacts tax legislation altering the tax treatment of qualified pension plans or distributions from such plans, transition relief is often provided to specific employers or individ-

ual taxpayers or to a class of employers or taxpayers. Transition relief generally delays temporarily or permanently the application of the enacted rule to the applicable taxpayer. Sometimes, transition relief will apply a modified rule that is a compromise between present law and the enacted rule.

The adoption of transition rules for a taxpayer or a class of taxpayers contributes to the actual and perceived complexity of employee benefits laws.

B. Issues and Analysis Relating to S. 1364

1. Nondiscrimination provisions

Definition of highly compensated employee

Two primary issues are presented by the present-law definition of a highly compensated employee: (1) the appropriate dollar or other cut-off point for the class of highly compensated employees and (2) the extent to which family members should be aggregated.

The development of a definition of a highly compensated employee must balance the administrative complexity for an employer in identifying those employees who are highly compensated and the need for a definition that does not create inappropriate results. Some argue that the definition of a highly compensated employee should probably be employer specific. Such a rule recognizes that compensation patterns will be affected by such factors as geographic location, employer size, and industry. However, such a definition can be unjustifiably complex to apply in the case of large employers with numerous operating divisions or lines of business.

The bill adopts a definition of highly compensated employee that utilizes a dollar compensation threshold and an ownership interest threshold to identify highly compensated employees. Under this definition, the level of the compensation threshold becomes the key issue—if the compensation threshold is set either too low or too high, it may permit an employer to discriminate against rank-and-file employees. However, no single compensation threshold will be appropriate for every employer. Thus, a definition of highly compensated employee that establishes a single compensation threshold may sacrifice theoretically accurate results in favor of a more administrable rule that achieves a rough justice in most cases.

On the other hand, present law permits employers to use a single dollar level of compensation rather than determining who is in the top-20 percent of employees. Thus, the bill can be viewed as streamlining the definition of compensation to eliminate unnecessary categories of highly compensated employees. This streamlining is also evident in the elimination of officers—in most cases officers will be either owners or highly compensated by virtue of their salary level so that the officer category is not necessary.

Family member aggregation also lends complexity to the definition of highly compensated employee under present law. The treatment of certain family members as a single highly compensated employee is designed to prevent income splitting to circumvent (1) the nondiscrimination rules or (2) the $200,000 limit on compensation taken into account. Theoretically, it might be argued that the family aggregation rule should apply to all highly compensated em-

ployees. However, the Congress has deemed family aggregation appropriate only in the case of employees who have sufficient control of an employer to manipulate the way in which compensation is paid. Some also argue that the present-law rules unduly restrict the provision of pension benefits in family businesses.

The bill eliminates the application of the family aggregation rule to the top 10 employees by compensation on the grounds that (1) in virtually all cases the employees who should be aggregated are 5-percent owners and (2) the additional administrative burden on employers to identify family members of the top 10 employees outweighs the small potential benefit of the rule.

Safe harbor definition of compensation

The bill provides a statutory safe harbor definition of compensation that should be easy for employers to administer. The bill permits the use of base pay, not basic rate of pay, which is already a permissible safe harbor definition of compensation under final Treasury regulations.

Minimum participation requirement

The minimum participation rule was adopted in the Tax Reform Act of 1986 because the Congress believed that it was inappropriate to permit an employer to maintain multiple plans, each of which covered a very small number of employees. Although plans that are aggregated for nondiscrimination purposes are required to satisfy comparability requirements with respect to the amount of contributions or benefits, such an arrangement may still discriminate in favor of the highly compensated employees. Final Treasury regulations address many of the concerns with the prior-law comparability rules that led to the enactment of the minimum participation rule. However, the potential for discrimination is always greater if an employer maintains multiple plans; no set of rules will be able to address all the possible differences between multiple plans.

The minimum participation rule was also viewed as a means of achieving the intent of the comparability requirements with less of the inherent complexity and administrative burdens imposed by the comparability rules. Any changes that limit the scope of the minimum participation rule reintroduces some complexity for employers and imposes additional burdens on the IRS in monitoring compliance.

The bill targets the application of the minimum participation rule to the class of plans—defined benefit pension plans—in which, some argue, the greatest potential for discrimination exists. This targeting could be viewed as an appropriate attempt to balance the effect of the minimum participation rule on employers with the interests of employees who might be affected by the operation of the rule. On the other hand, some might argue that the minimum participation rule has the most significant effect on small employers and that it is difficult to understand the justification for a small employer maintaining a multitude of plans for its employees, regardless of the type of plan.

In addition, the bill's provision may provide an incentive for employer's to maintain defined contribution plans because such plans are not subject to the minimum participation rule. Some may

argue that this incentive is inappropriate at a time when fewer new defined benefit plans are being established.

Nondiscrimination requirements for qualified cash or deferred arrangements and matching contributions

The sources of complexity generally associated with the nondiscrimination requirements for qualified cash or deferred arrangements and matching contributions are the recordkeeping necessary to monitor employee elections, the calculations involved in applying the tests, and the correction mechanism, i.e., what to do if the plan fails the tests. None of these factors is new—some form of the nondiscrimination test has been in the law since 1978. Changes to these rules made by the Tax Reform Act of 1986 may have added to the complexity of the rules in operation.

The Tax Reform Act narrowed the permitted disparity between contributions by highly compensated employees and contributions by nonhighly compensated employees. Plans which previously passed the nondiscrimination tests may not meet the new rules, thereby placing more focus on the nondiscrimination rules themselves, as well as on the procedures for correcting failures to satisfy the rules. The Tax Reform Act also imposed a separate dollar limitation on annual elective deferrals of employees ($8,475 for 1991); some people believe that this dollar limitation obviates the need for nondiscrimination tests or obviates the need for nondiscrimination tests based on actual utilization of the cash or deferred arrangement. However, the dollar cap on elective deferrals limits the deferrals of highly compensated employees, but does not, by itself, ensure that there is adequate participation in the arrangement by rank-and-file employees.

The Tax Reform Act also added the special nondiscrimination rules for employer matching contributions and after-tax employee contributions. These rules added a new layer of testing and, therefore, of complexity for qualified cash or deferred arrangements (called section 401(k) plans), because an employer match is typically a part of such arrangements.

The changes made in the Tax Reform Act of 1986 were enacted because Congress was concerned that the rules relating to qualified cash or deferred arrangements encouraged employers to shift too large a portion of the share of the cost of retirement savings to employees. Congress was also concerned that the nondiscrimination rules permitted significant contributions by highly compensated employees without comparable participation by rank-and-file employees, a result which some believe is inconsistent with a basic reason for extending favorable tax treatment to employer-provided pension plans.

On the other hand, it is argued that the complexity of the nondiscrimination requirements, particularly after the Tax Reform Act changes that impose a dollar cap ($8,475 for 1991) on elective deferrals, is not justified by the marginal additional participation of rank-and-file employees that might be achieved by the operation of these requirements. Some argue that the rate of rank-and-file employee participation in cash or deferred arrangements is more directly related to the age of the employee than to the employee's compensation and that the nondiscrimination rules do not take this

factor into account. They believe that the failure of young employees, who are more likely to be nonhighly compensated, to make elective deferrals should not restrict the ability of older employees to contribute to their retirement savings. Further, the definition of a highly compensated employee may include some middle-income taxpayers for whom adequate retirement savings is essential and the operation of the nondiscrimination rules may prevent such an employee from saving.

Some people believe that the Tax Reform Act unnecessarily restricted the ability of highly compensated employees to save for retirement. The fact that the Federal Government waived the application of nondiscrimination requirements to the cash or deferred arrangement maintained for Federal employees is often cited as a justification for the repeal of the special nondiscrimination test for all employers. In addition, they argue that the result that the nondiscrimination rules is intended to produce can also be achieved by creating an incentive for employers to provide matching contributions on behalf of rank-and-file employees. Matching contributions, it is argued, create a sufficient inducement to rank-and-file employee participation.

Some practitioners have suggested that the present-law nondiscrimination tests should be eliminated or replaced with a design-based test. Under a design-based test, a plan is nondiscriminatory if it is designed in a certain way. Some people have serious tax and retirement policy concerns with a test that is not based on actual contributions and would argue that such a test permits cash or deferred arrangements to operate essentially like an individual retirement arrangement (IRA) with a much higher contribution limit ($8,474 for 1991). This type of IRA-equivalent arrangement is only available to employees whose employers offer such a plan. Thus, some would argue that the absence of nondiscrimination rules based on actual utilization would cause the Federal tax laws to treat similarly situated taxpayers differently.

Some believe that a test based on actual participation is the best way to prevent elective plans from disproportionately benefiting high-paid employees and the only way to ensure that low-paid employees actually benefit under the plan. It is argued that special nondiscrimination rules are necessary in the case of elective plans because higher income employees naturally are in a position to defer greater amounts of income than lower paid employees. Indeed, if an elective plan is the employee's only retirement plan, lower income employees may not be able to defer enough current income to provide sufficient retirement income. For this reason, some believe that elective retirement plans do not operate as efficiently as nonelective plans from a retirement policy perspective.

However, some argue that the adoption of a design-based nondiscrimination test for cash or deferred arrangements and matching contributions will promote expanded coverage for rank-and-file employees. The adoption of a nondiscrimination safe harbor that eliminates the testing of actual contributions to the plan removes a significant administrative burden that may act as a deterrent to employers who would not otherwise set up such a plan. Thus, the adoption of a simpler nondiscrimination test may encourage more employers, who do not now provide any tax-favored retirement

plan for their employees, to set up a plan. However, some argue that the rapid rate of establishment of cash or deferred arrangements is inconsistent with arguments that the nondiscrimination requirements act as a deterrent to employers to set up such plans.

The bill addresses concerns that rank-and-file employees may not participate by requiring a certain level of employer contributions. These contribution provide an incentive for lower-paid employees to contribute. In addition, the bill assures that lower-paid employees will be aware of the plan by requiring employers to communicate the plan to employees.

In addition, a design-based nondiscrimination test provides certainty to an employer that does not exist under present law. Under such a test, an employer will know at the beginning of each plan year whether the plan satisfies the nondiscrimination requirements for the year. On the other hand, some point out that there are alternative ways to achieve this result.

Under the bill, the design-based nondiscrimination tests are provided as alternatives to the present-law nondiscrimination tests. The addition of optional methods of satisfying the nondiscrimination requirements for cash or deferred arrangements may be perceived by some employers as adding, rather than reducing, the complexity of the requirements.

2. Distribution rules

In general

The pension distribution rules have been uniformly identified as a primary candidate for simplification by employers, practitioners, policy-makers, and the IRS. These rules affect nearly 16 million individual taxpayers and often require complex calculations that are difficult for the average taxpayer to perform. Many have suggested that a major part of any pension simplification proposal should be the distribution rules.

Rollovers

The present-law rules relating to rollovers of distributions from a qualified plan to an IRA or to another qualified plan represent an exception to the fundamental principle that income should be taxed when it is actually or constructively received. The rollover rules are intended to facilitate the retention of retirement savings for retirement purposes when an individual either (1) separates from service prior to retirement age or (2) receives a lump-sum distribution from a plan.

The rollover rules originally were available only in the case of certain lump-sum distributions. Because the original rollover provisions created harsh results in the case of inadvertent failures to receive a lump-sum distribution, the Congress has liberalized the rollover rules. However, the liberalizations, while eliminating most of the harsh results, have complicated the rollover rules to the point that the average plan participant will be unable to determine in many cases whether a distribution can be rolled over. The restrictions on rollovers under present law lead to numerous inadvertent failures to satisfy the rollover requirements and contribute signifi-

cantly to the complexity of the rules relating to the taxation of pension distributions.

The bill addresses the complexity of the present-law rollover rules by permitting any distribution (other than a minimum required distribution) to be rolled over to another qualified plan or an IRA. The bill does not permit the rollover of after-tax employee contributions—the concern with permitting rollovers of employee contributions is primarily administrative rather than a policy concern. Permitting the rollover of employee contributions is consistent with retirement policy; individuals should be permitted to keep all their retirement savings in a tax-favored arrangement until retirement. However, the administrative problems of keeping track of basis in an IRA should not be underestimated. Employers maintaining qualified plans to which after-tax employee contributions have been made often comment that they would like to eliminate recordkeeping burdens by cashing out employee contributions. Permitting such contributions to be rolled over to an IRA would merely shift, rather than solve, the recordkeeping problems. Indeed, such problems could be worse in an IRA because IRA funds may be freely transferred between accounts.

Lump-sum distributions

The original intent of the income averaging rules for lump-sum distributions was to prevent a bunching of taxable income because a taxpayer received all of the benefits in a qualified plan in a single taxable year. While the income averaging rules provide a benefit to taxpayers, they also create complexity by requiring complex calculations that the average taxpayer has difficulty understanding. In addition, the existence of these rules has generated additional complexities under present law in the definitions of those distributions that qualify for the favorable treatment and in the restrictions on rollovers between tax-favored retirement arrangements that are needed to prevent taxpayers from shifting retirement assets in order to elect income averaging with respect to more assets.

The need for rules to prevent bunching of income has arguably been significantly reduced. The reduction and compression of tax rates in the Tax Reform Act of 1986 significantly reduces the adverse tax effect for a taxpayer who receives a lump-sum distribution. Moreover, the bill's liberalization of the rollover rules increases the flexibility of taxpayers in determining the timing of the income inclusion of pension distributions.

Some also argue that averaging should be eliminated from a retirement policy perspective. It can be argued that the Federal tax laws should not create an incentive for taxpayers to take pension distributions in lump sums. In fact, some studies have shown that significant percentages of lump-sum distributions are used for nonretirement purposes.

Some argue that the bill's retention of the present-law rules for net unrealized appreciation on employer securities unnecessarily preserves some of the complexity of present law. Thus, for example, the definition of what constitutes a lump-sum distribution could be eliminated from the Code if the rule for net unrealized appreciation were repealed. Some also argue that, like the averaging

rules, the need for the special unrealized appreciation rule is reduced by liberalizing the rollover rules.

The bill also does not eliminate the present-law transition rules relating to the 1986 Act repeal of capital gains treatment for certain lump-sum distributions and the continued availability of 10-year income averaging for certain individuals. The retention of these transition rules undercuts much of the simplicity attained by repeal of 5-year income averaging. On the other hand, the transition rules were added in the 1986 Act to reflect the reliance that plan participants may have had on the availability of favorable tax treatment for withdrawals and the elimination of these rules could be viewed as unfair to those individuals who are eligible for the transition rules. Of course, the reliance problem could be addressed by providing a limited period of time (such as 1 year) after the enactment of the bill during which individuals could receive distributions that are eligible for the transition rules.

Transfers to IRAs or eligible transferee plans

The provision in the bill requiring a trustee-to-trustee transfer of certain distributions from qualified plans to an IRA or a defined contribution plan that accepts such distributions is intended to promote sound retirement policy. Such a transfer requirement eliminates the adverse income tax effect that occurs when an employee receives a distribution from a qualified plan but inadvertently fails to roll the distribution over to an IRA or another qualified plan within the permitted rollover period. Further, the bill provision reduces the likelihood that retirement savings will be spent for nonretirement purposes by forcing the employee to take an affirmative action (withdrawal from the transferee plan) in order to have access to the distribution. It can be argued that such a provision may make it more likely that at least a portion of retirement savings will remain in a tax-favored arrangement and that the employee will have adequate sources of retirement income when it is needed.

On the other hand, the provision may create an additional administrative burden for the employer by requiring the plan trustee to designate a transferee plan if the employee does not designate a plan. Generally, this will mean that the plan trustee will be required to set up an IRA on behalf of the employee if the employee fails to designate an IRA. In addition, the bill requires the plan trustee to notify employees of the requirements of the transfer provision and of the amount to be transferred. Thus, the provision imposes an additional reporting requirement on employers or plan trustees. Some employers and trustees may also be concerned about continuing fiduciary liability with respect to amounts transferred.

The benefits of the transfer provision (i.e., promoting additional retirement savings) must be balanced against the administrative burdens on employers.

Required distributions from qualified plans

A uniform distribution rule for pension benefits was adopted because it reduces disparities in opportunities for tax deferral among individuals covered by different types of plans and eases adminis-

trative burdens. The minimum distribution rules are designed to ensure that plans are used to fulfill the purpose that justifies their tax-favored status—replacement of a participant's preretirement income at retirement—rather than for the indefinite deferral of tax on a participant's accumulation under the plan.

Some will argue that the application of the required distribution rules to all employees under present law is unnecessary because the vast majority of employees commence distributions prior to age 70. Only in the case of very highly compensated employees is the potential for deferral of receipt of benefits a problem.

The required distribution rule under present law has the effect of eliminating an incentive that employers use to get their employees to retire. Employers prefer to be able to induce employees to retire, thereby creating jobs for younger employees, by refusing to commence payments of retirement benefits. Under present law, this option is not available to employers; however, the bill will permit employers to utilize this incentive.

On the other hand, the bill also requires a plan administrator to actuarially adjust the benefits payable to an employee under a defined benefit pension plan to reflect the period during which benefits could have been paid, but were not. This provision can also serve as a disincentive to employees to retire because they will not lose the actuarial value of the retirement benefits they could have been receiving. This provision is necessary to prevent employees from being disadvantaged because payment of their benefits is delayed; however, it also adds complexity.

The return to the pre-1986 Act rules relating to required distributions also reintroduces some of the complexities the 1986 Act sought to eliminate. Thus, for example, employers will have to apply different sets of rules to two different groups of employees. Also, it may be difficult to determine when someone has retired. For example, is someone retired for purposes of the minimum distribution rules if they are working for the employer on a part-time basis?

3. Miscellaneous provisions

Treatment of leased employees

The leased employee rules are designed to prevent circumvention of the pension plan qualification rules. The coverage and nondiscrimination rules operate by comparing an employer's highly compensated employees and nonhighly compensated employees. The possibility for discriminating in favor of highly compensated employees increases to the extent that an employer can reduce the number of individuals required to be counted as nonhighly compensated employees through arrangements such as leasing. For example, one obviously abusive type of transaction that Congress was concerned about in enacting the leasing rules were cases in which a doctor would fire his staff and then rehire the same people through a leasing organization. The former employees would no longer be considered employees of the doctor, enabling the doctor to set up a generous qualified plan that covered only himself.

Avoidance of the qualification rules through employee leasing is possible because the common-law rules for determining who is an

employee are concerned primarily with who is the appropriate party from whom to collect withholding taxes and, in some cases, for determining whether or not an individual is an employee or an independent contractor. The same factors that are relevant to such a determination are not necessarily those that are most relevant in determining those situations which undermine the pension rules.

The primary concern articulated with respect to the present-law rules is that the statute, as interpreted by proposed regulations, is overly broad and counts as leased employees individuals who should not be considered such. There is also some concern that it is difficult to obtain the information necessary to determine who is a leased employee because some of the information is obtainable only from a third party and is not readily accessible by the employer.

Most would agree that the present-law rules as they now stand are overly broad; however, there is debate about the appropriate solution. Some argue that the "control" test of the bill is preferable to present law because it relies solely on information within the control of the employer. Thus, the employer may more easily make a determination of who are considered leased employees. They also argue that the "historically performed" test has no relation to the economic relationship between the recipient and the individual, and that it is the nature of that relationship that should be determinative.

On the other hand, the control test of the bill may create some confusion as employers and practitioners try to distinguish it from the control test used to determined whether an individual is a common law employee. Leased employees are by definition individuals who, under the common law test, are not employees. Use of similar terms without clarification of their meaning can create administrative problems for employers and enforcement problems for the IRS.

There is also some concern that the bill will be perceived as merging the rule with the common-law test, with the result that some individuals, such as doctor office technicians, who clearly were intended to be covered by the rules are not. Thus, the more the test appears to be like the common law test, the greater the concern that the bill's rule will not be sufficient to prevent avoidance of the nondiscrimination requirements.

Some also question whether true simplification of the rules can be achieved statutorily. The determination of whether someone should be a leased employee is inherently factual in nature. It depends on the underlying economic relationship of the parties—a factor which will vary case by case with each individual. Thus, some argue that it is the case-by-case analysis that is relevant. This case-by-case analysis approach could be implemented with minor statutory changes to the employee leasing rules with direction to the Secretary in the legislative history as to the kinds of circumstances that the Congress believes should and should not result in someone being considered a leased employee.

Plans covering self-employed individuals

The repeal of the remaining special rules for plans maintained by unincorporated employers should make the qualification standards easier to apply and should eliminate the need for special re-

strictions on rollovers between plans if one plan is a plan of an unincorporated employer.

Full funding limitation of multiemployer plans

It is argued that the application of the full funding limitation to multiemployer pension plans creates significant complexity. It is necessary to determine (1) whether the full funding limit applies on a contributing employer-bycontributing employer basis and (2) who bears the burden of the sanction if the rule is violated. In addition, given the intent of the full funding limitation, it is arguable that this limitation need not apply to multiemployer plans because the contributing employers to the plan have no interest in making excess contributions to the plan. The nature of the collective bargaining process and the fact that unrelated employers are contributing to the same pension plan should act as a sufficient deterrent without the imposition of a separate funding restriction.

On the other hand, some argue that it is difficult to understand why the arguments against the full funding limitation might not also be relevant in the case of a collectively bargained plan that is not a multiemployer plan or in the case of a multiple employer plan.

Affiliation requirements for employers jointly maintaining a VEBA

The rules relating to VEBAs under present law permit an employer and, in some cases, a group of employers to contribute to a tax-exempt trust that is established to provide benefits to employees of the employer or group of employers. By generally providing tax exemption for the earnings on amounts contributed to a VEBA, present law reduces the cost to an employer or a group of employers of providing certain benefits.

To the extent that the VEBA rules provide more favorable income tax treatment than is provided to an insurance company, use of a VEBA may encourage an employer or group of employers to self insure benefits rather than purchasing insurance from a commercial insurance company. Thus, any proposal that recommends the liberalization of restrictions applicable to VEBAs should be viewed in light of their potential interaction with the insurance company tax rules. In fact, some people argue that the present-law VEBA rules, which permit employers in the same line of business operating within the same State to establish a VEBA, permits a group of employers to establish what is, in effect, a tax-exempt insurance company for the funding of health and life benefits for employees. Thus, it could be argued that the justification for permitting unrelated employers to establish a VEBA should be reexamined.

However, some may conclude that the liberalization of the VEBA rules is justified because VEBAs serve the public policy of ensuring that employers have set aside sufficient funds to provide benefits to their employees. In addition, it may be argued that it is inappropriate to try to compare VEBAs with commercial insurance companies because there are inherent differences in the way that VEBAs operate. For example, a VEBA is established by an employer or a group of employers who have a significant nexus whereas an insurance company will typically serve a diverse clientele. Similarly, a

VEBA exists for the funding of a statutorily limited class of benefits; a commercial insurance company will typically have many products for sale to the general public.

The bill provides that employers will be deemed to be affiliated if certain requirements are satisfied. Although historically the notion of affiliated employers has been linked to some kind of common ownership, the bill permits unrelated employers to be treated as affiliated. In connection with this provision, it is appropriate to consider whether the concept of affiliation adopted in the bill should be extended to other areas in the tax laws, or at least to the employee benefits area. For example, such a concept could be extended to apply to the group of employers that is tested together for nondiscrimination purposes under the qualification rules for pension plans.

Salary reduction SEPs

Pension coverage of employees of small employers is significantly lower than that of employees of medium or large employers. A number of factors may contribute to this, including the cost to the employer (both in terms of wage cost and administrative cost of maintaining the plan) as well as the desire of the employees to have pension benefits rather than wages in other forms. The bill attempts to address one factor that may affect an employer's decision to establish a pension plan—administrative burdens—by enabling an employer to establish a salary reduction SEP without testing to ensure that the plan operates in a manner that does not discriminate in favor of highly comensated employees.

Nondiscrimination rules generally are enacted to ensure that the tax benefits for qualified plans benefit an employer's rank and file employees as well as highly compensated employees and to provide broad-based pension coverage. The issues relating to nondiscrimination rules are discussed above under the provision relating to cash or deferred arrangements. The discussion applies equally to the provision that permits salary reduction SEPs for small employers without testing for nondiscrimination.

In addition, even if one concludes that nondiscrimination rules are generally desirable from a policy perspective, some argue that in the case of small employers such rules may be an impedient to establishment of any type of retirement program and that relaxation of such rules is appropriate if doing so will encourage small employers to establish retirement plans.

It is unclear, however, whether elimination of nondiscrimination rules for small employers will actually increase pension coverage of rank and file employees. Such employers may establish SEPs now, and may also establish qualified retirement plans that are relatively easy to administer. Thus, the fact that pension coverage is lower in smaller firms may have little to do with administrative costs associated with nondiscrimination rules. Thus, relaxing those rules may not achieve the desired result.

Some also argue that any increased pension contributions by small employers will be reflected in lower wages (to the extent permitted by minimum wage laws)—which could adversely affect lower-income workers who may desire to have higher current wages. Some also argue that the provision may make hiring mini-

mum wage workers more expensive, so that fewer of such workers will be hired.

Some also argue that it is not fair to provide special rules to small employers only, and that one set of rules ought to apply to all employers. In addition, as a practical matter, it may be difficult to limit special provisions to small employers only. Thus, some argue that exceptions for small employers should be adopted only if it is appropriate from a policy perspective to eliminate nondiscrimination rules for all employers.

Amending the eligibility requirements for SEPs would conform the rules for SEPs more closely to the rules relating to qualified plans and thus may operate to simplify the pension system generally. On the other hand, such rules require employers to keep track of actual hours worked by employees, which may increase the recordkeeping burdens imposed on small employers.

A one-year of service rule permits an employer to require that an employee complete 1,000 hours of service (or work approximately 20 hours per week) in order to qualify for a contribution on the employee's behalf to the employer's pension plan. Long-term, part-time employees would be entitled to a contribution under present law. To the extent that employees of small employers work on a periodic or part-time basis, however, the change to a one-year of service requirement may reduce the number of employees covered by a pension plan.

Treatment of certain governmental plans

Proponents of the provision in the bill modifying the limits on contributions and benefits for governmental plans argue that such plans have special circumstances that warrant exceptions from the general rules. For example, with respect to the exemption from the 100 percent of compensation limitation, they argue that the compensation structure for certain government positions is such that the employees are paid very low current compensation, but are compensated instead with retirement benefits. Also, they argue that in the private sector, disability and similar benefits are often paid outside of a qualified plan, whereas they are paid from qualified plans in the public sector. Further, they argue that private employers are allowed to maintain excess benefit plans (i.e., plans that pay benefits that cannot be paid from a qualified plan because of the limits on contributions and benefits), but public plans cannot maintain excess benefit plans because of the limitations imposed under section 457 (discussed below). Finally, they argue that the scrutiny afforded compensaiton of public employees is sufficient to ensure that excessive benefits are not paid and that no further Federal limitations are necessary.

Opponents of the provision argue tht the provision is merely an exemption from the limits on contributions and benefits, and that the public employees should not be treated more favorably than private sector employees. For example, all low wage employees could benefit from an exemption from the 100 percent of compensation limitation. Similarly, many private employers have pointed out that lower-paid employees are hurt because compensation for purposes of the limits on contributions and benefits does not include salary reduction amounts, such as contributions to a 401(k)

plan. Further, they argue that as a matter of public policy, public plans should be subject to the same rules as plans of private employers and that employees in public plans obtain significant Federal tax benefits under qualified plans.

Distributions from rural cooperative plans

In general, a qualified cash or deferred arrangement is required to be a profit-sharing or stock bonus plan. Under either type of plan, present law normally permits in-service withdrawals. In fact, the withdrawal rules relating to a qualified cash or deferred arrangement are generally more restrictive than the withdrawal rules applicable to other profit-sharing or stock bonus plans.

Certain pre-ERISA money purchase pension plans and pension plans maintained by rural cooperatives can also be qualified cash or deferred arrangements. Because these plans are pension plans, no in-service withdrawals are permitted, notwithstanding the fact that certain in-service withdrawals are permitted from qualified cash or deferred arrangements. In the case of a plan maintained by a rural cooperative, it can be argued that this is an unnecessary restriction on withdrawals since a rural cooperative plan is structured as a pension plan only because rural cooperatives do not have profits within the general meaning of the Code so that, at the time the plans were established, they could not be profit-sharing plans.

On the other hand, some might argue that the liberalization of the withdrawal rules to permit in-service distributions is inconsistent with sound retirement policy in that it creates an incentive for plan participants to dissipate retirement savings for nonretirement purposes. In addition, such a rule creates a class of pension plans that are subject to more favorable withdrawal rules, which might be perceived as unfair to other employers not eligible for the special rules.

Cash or deferred arrangements for tax-exempt organizations

Under present law, nongovernmental, tax-exempt employers which are not charitable (sec. 501(c)(3)) organizations or public educational institutions (sec. 170(b)(1)(A)(ii)) are prohibited from providing their employees with qualified retirement plans that permit elective contributions. Moreover, rank-and-file employees of such organizations are effectively barred from participating in nonqualified deferred compensation plans because of the ERISA funding rules. By permitting tax-exempt organizations to establish qualified cash or deferred arrangements under section 401(k), the bill eliminates the problem that rank-and-file employees of tax-exempt organizations face in having meaningful elective deferred compensation plans available to them.

Date for adoption of plan amendments

The provision that delays the time by which plan amendments are required in order to bring the plan into compliance with the changes made by the bill benefits the employer in 2 ways. First, the provision gives the employer additional time to make the necessary changes in the plan document. Second, it provides time during which the IRS can issue additional guidance with respect to

he requirements and such guidance can then be incorporated into he plan document, which will reduce the need for subsequent plan amendments.

On the other hand, the operation of the provision means that plan administrators and participants will not be able to rely on the anguage of the plan document in determining what their rights night be under the plan. In addition, the plan document represents he contract between the employer and its employees and such contract should be kept as current as possible. The benefit of the additional time for employers should be balanced against the importance of employees being able to determine their rights and of plan administrators being able to administer the plan properly.

V. OTHER PROPOSAL

S. 318 (Senator Packwood and others): The PRIME Retirement Account Act of 1991

Simplified retirement plan

The bill creates a simplified retirement plan for small business called the private retirement incentives matched by employers (PRIME) account.

A PRIME account is an individual retirement plan with respect to which the only contributions allowed are contributions under a qualified salary reduction arrangement. A qualified salary reduction arrangement is a written arrangement of an eligible employer under which an employee can make elective salary reduction contributions to a PRIME account. The amount of such contributions must be expressed as a percentage of the employee's compensation, and are capped at $3,000 per year. The employer is required to match employee contributions to the extent such contributions do not exceed 3 percent of the employee's compensation. No other matching contributions are allowed.

Only employers who normally employ fewer than 100 employees on any day during the year and who do not maintain a qualified plan can establish PRIME accounts for their employees. For this purpose, a qualified plan includes a qualified retirement plan described in section 401(a), a qualified annuity plan (sec. 403(a)), a governmental plan, a tax-sheltered annuity (sec. 403(b)), and a simplified employee pension (sec. 408(k)).

All employees of the employer who are reasonably expected to work at least 1,000 hours during the year are eligible to participate in the PRIME account. All contributions to an employee's PRIME account are fully vested.

No nondiscrimination rules apply to PRIME accounts.

A PRIME account is not an employee benefit plan for purposes of ERISA. A PRIME account is, however, considered a pension plan for purpose of the restrictions on deductible contributions to an individual retirement arrangement (IRA) (sec. 408(g)).

Tax treatment of PRIME accounts

The tax treatment of PRIME accounts generally is the same as that of simplified employee pensions (SEPs). Thus, contributions to an employee's PRIME account are not includible in the employee's gross income (sec. 402(h)). Distributions form a PRIME account generally are taxed under the rules applicable to IRAs (sec. 408(d)). However, distributions from a PRIME account may be rolled over only to another PRIME account.

Early withdrawals from a PRIME account generally are subject to the 10-percent early withdrawal tax applicable to IRAs (sec.

72(t)). However, withdrawals of contributions during the 3-year period beginning on the date the employee first participated in the PRIME account are subject to a 25-percent early withdrawal tax (rather than 10 percent).

Reporting requirements

The trustee of a PRIME account is required each year to prepare, and provide to the employer maintaining the account, a summary description containing basic information about the account. Within 30 days after each calendar quarter, the trustee also is required to furnish, to each individual maintaining a PRIME account a statement with respect to the account balance as of, and the activity during, such calendar quarter. In addition, the trustee is required to file a one-time report with the Secretary of Labor providing information required under regulations issued by the Secretary. A trustee who fails to provide any of such reports or descriptions is subject to a penalty of $100 per day until such failure is corrected.

The employer maintaining a PRIME account must notify each employee of the employee's opportunity to make salary reduction contributions under the account immediately before the employee becomes eligible to make such election. This notice must include a copy of the summary description of the account prepared by the trustee. An employer who fails to provide such notice is subject to a penalty of $100 per day on which such failure continues. The employer also must provide such simplified reports with respect to the account as the Secretary may require by regulations.

No other reports are required.

Effective date

The bill is effective for taxable years beginning after December 31, 1991.

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